April 29, 2002
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/17

10:00 a.m., February 20, 2002

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Executive Board Attendance

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

Executive Directors	Alternate Executive Directors
	A.S. Alosaimi
	A.S. Al Azzaz, Temporary
	D. Ondo Mañe
	M. Kabedi-Mbuyi, Temporary
	T.P. Nguema-Affane, Temporary
	F. Vermaeten, Temporary
	C.J. Faircloth, Temporary
M.J. Callaghan	D.C. Guinigundo
	D. Baasankhuu, Temporary
R.F. Cippà	W. Szczuka
	F. Zurbrügg, Temporary
K. Bischofberger	C. Harzer, Temporary
	F. Haupt, Temporary
P.C. Padoan	H. Vittas
	C.A.E. Sdralevich, Temporary
D.I. Djojosobroto	H.E. Phang, Temporary
	R. Gauba, Temporary
	P.R.D. Prasad, Temporary
W. Kiekens	C. Josz, Temporary
	K. Sazanov, Temporary
	B. Andersen
	A. Alber, Temporary
	M. Lundsager
	A. Baukol, Temporary
	P.A. Dohlman, Temporary
	S. Boitreaud
	S. Le Gal, Temporary
	M. Daïri
	A. Monajemi, Temporary
	J.K. Kwakye, Temporary
	Y. Lissovolik, Temporary
	S. Vtyurina, Temporary
	O.E. Garner, Temporary
	R. Villavicencio, Temporary
	E. González-Sánchez, Temporary
T. Scholar	M.A. Brooke
	B. Kelmanson, Temporary
	N. Joicey, Temporary
M. Portugal	A. Maciá, Temporary
	A. Rambarran, Temporary
	I. Usman
	J. Mafararikwa, Temporary

	G.M. Campos, Temporary
A.S. Shaalan	M.B. Chatah
	S.A. Bakhache, Temporary
	T. Koranchelian, Temporary
Wei Benhua	Z. Jin, Temporary
	P.A. Nijsse, Temporary
	D. Radev, Temporary
	M. Yanase, Temporary
	Y. Saito, Temporary
A.G. Zoccali	R. Maino, Temporary
	D. Vogel, Temporary

S.J. Anjaria, Secretary
A. Linde, Acting Secretary
A. Mountford, Acting Secretary
Z.R. Ahmed, Assistant
R. Gudmundsson, Assistant
J. Morco, Assistant

Also Present
IBRD: J. Kolster, HIPC Unit; T. Duvall, Legal Department; C. Gray, C. Garrity, Poverty Reduction and Economic Management Network; C. Petersen, Europe and Central Asia Regional Office; F. Mamedov, Office of Executive Director. African Department: N. Kirmani, A. Tahari. Asia and Pacific Department: A. Lopez-Mejia. European II Department: O. Havrylyshyn, Deputy Director; R. Abdoun, M. Pani, Y. Sun, J. Wakeman-Linn. External Relations Department: J. Starrels. Fiscal Affairs Department: T.M. Ter-Minassian, Director; G. Abed, E. Ahmad, R. Bhattacharya, J. Brumby, K. Chu, B. Clements, S. Danninger, J. Diamond, K. Fletcher, S. Gupta, C. McDonald, C. Schiller, Legal Department: F.P. Gianviti, General Counsel; R. Leckow, M. Milford. Policy Development and Review Department: G. Anayiotos, C. Aturupane, L. Ebrill, M. Hadjimichael, S. Kashiwagi, B. Loko, M. Ronci, D. Ross, Secretary's Department: L. Hubloue, M. Miller, P. Ramlogan, T. Turner-Huggins. Statistics Department: J. Bove. Treasurer's Department: C. Hemus, J. Lin. Western Hemisphere Department: L. Cardemil, P. Druck, J. Toro. Office of the Managing Director: C. Salmon, Personal Assistant; A. Mazarei, R. Moghadam, T. Wolde-Semait, R.S. Teja. Advisors to Executive Directors: M.P. Bhatta, A.R. Ismael, D.H. Kranen, Liu F., M.F. Melhem, E. Pinto Moreira. Assistants to Executive Directors: J.G. Borpujari, S., Boucher, N.J. Davidson, I. Kupča P. Lathouly, J. Milton, T. Moser, M.L. Nikitin, K.S. Oo, T. Segara, B. Siegenthaler, J. Sipko, Wei X., Yu J.Y.

1. MESSAGE OF CONDOLENCE

The Acting Chair delivered a message of condolence on the death of Mr. Huw Evans, advisor in the Monetary and Exchange Affairs Department and former Executive Director for the United Kingdom for the Fund and the World Bank.

2. INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—DEBT SUSTAINABILITY ANALYSIS AND NONCOMPLYING PURCHASES AND DISBURSEMENTS; AND PRGF-HIPC TRUST—AMENDMENT

Documents: HIPC Initiative—Debt Sustainability Analysis and Noncomplying Purchases and Disbursements (EBS/02/18, 2/1/02)

Staff: Hadjimichael, PDR; Leckow, LEG; Ross, PDR; Kolster, IBRD

Length: 1 hour, 55 minutes

The staff submitted the following statement:

> We would like to provide Executive Directors with some background information that may help put the staff paper (EBS/02/18) in context.
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> The urgency of considering this issue ahead of the Board discussion of the broader considerations of information reporting in the context of the HIPC Initiative is necessitated by the imminent Board discussion of the HIPC Decision Point document for Ghana, now scheduled for Friday, February 22. As Directors are aware, Ghana was found to have received a noncomplying disbursement that was subject to an early repayment expectation as a result of misreporting under its PRGF arrangement that affected its debt to the Fund as of end-2000, the base period for HIPC relief. In line with the methodology proposed in EBS/02/18, Ghana’s decision point paper (EBS/02/20) excludes the relevant amounts from the HIPC relief calculations.
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> We have been working with our World Bank colleagues over the past several months on a follow-up to the paper on Misreporting in the Context of HIPC Initiative Assistance—Preliminary Considerations (EBS/00/245), discussed by the Board on December 11, 2000. A number of difficult issues had to be addressed that led to a somewhat lengthy internal preparation process, but we expect to be able to issue very soon (for discussion in late March) two Board papers on the broader issue of information reporting in HIPC cases. The first one, written jointly with World Bank staff, will present a framework for the institutions to handle revisions to data underlying the calculation of HIPC relief and situations where interim assistance was disbursed on the basis of misreported information on the policy track record. The second paper, prepared by PDR and LEG, will present the amendments to

the PRGF/HIPC Trust instrument that would be required to give effect—in the Fund—to the approach proposed in the first paper.

Regarding EBS/02/18, we would like to clarify that the proposals could give rise to a reduction in debt relief from all creditors. This is because a new (lower) debt stock would be calculated—excluding any early repurchase obligations—and, based on it, a new (lower) common reduction factor would be derived for creditors' claims.

Mr. Kiekens submitted the following statement:

I agree that, from now on, the amounts subject to an early repurchase or repayment expectation under the misreporting guidelines will not be considered as external debt for the purpose of calculating debt sustainability under the HIPC Initiative.

The proposed decision does not specify any time limitation or limitation of the amount for recalculating HIPC assistance after misreporting. However, the staff comments make it clear that if the repayment expectation is established after the completion point, no recalculation or adjustment of HIPC assistance will be made. Footnote 5 of the staff report also mentions that "any reduction in the amount of the commitment could not, in any event, exceed the amount of the commitment remaining to be disbursed at the completion point."

This is not acceptable. It could occur that even though the Managing Director informed the country, before the completion point, that there may be a case of misreporting, the Board does not establish an early repurchase or repayment expectation until after the completion point is passed. Nor is there any overriding reason not to ask reimbursement of what has been mistakenly disbursed.

Admittedly, there should be a reasonable time limit after which no recalculation is possible. In cases where the calculation of debt sustainability was erroneous because amounts due under an early repurchase or repayment expectation were not excluded from the external debt, such a time limit is implied. Indeed, no early repurchase or repayment expectation can be established unless the Managing Directors has notified the authorities within four years after the noncomplying purchase that he is opening an investigation.

In sum, I agree with the proposed decision as drafted, provided it is understood that recalculations and adjustments of HIPC assistance are possible after the completion point and that the Fund can ask for reimbursement of what has been disbursed in error.

> In all other cases of misreporting affecting the amount of HIPC assistance, it would be a wise policy to introduce a statute of limitations like that existing under the misreporting guidelines: no recalculation of HIPC assistance can occur after the completion point unless the Managing Director has notified the country, within four years after the completion point, that he is opening an investigation into a possible misreporting affecting the debt sustainability calculation.
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> On March 17, 2000, the Board agreed to revisit this last issue. On December 11, 2000, the Board held an inconclusive seminar on this issue, and Management promised to make new proposals soon. If the Board cannot decide today on this issue, I ask that it be placed on the Board's agenda within the next four weeks.

Mr. Daïri noted that the discussion on Ghana had been postponed due to the fact that the Board had first to decide on how to treat cases where a case of misreporting was discovered prior to a country reaching its decision point. It would be therefore better if the Board could limit the discussion on how to treat these cases and to discuss at a different meeting the broader issues relating to misreporting discovered after the decision point. Complex coordination with other creditors would arise once the decision point had been reached. Such an approach could also eliminate the risk of postponing the Ghana discussion because of difficulties in reaching consensus on much broader issues.

The staff representative from the Legal Department (Mr. Leckow) noted that any changes to Fund policy with regard to cases of misreporting under the HIPC Initiative that were approved after Ghana reached its decision point could not be applied retroactively to the commitment of HIPC Initiative resources for Ghana.

The Acting Chair (Ms. Krueger) asked Executive Directors whether they supported Mr. Daïri's proposal of simply deciding on how to treat cases of misreporting that occur prior to the decision point and to leave all other issues related to information reporting in the context of HIPC Initiative assistance for the upcoming Board discussion on that issue.

Mr. Kiekens expressed disappointment that almost two years would have passed since the Board had requested a discussion on misreporting under the HIPC Initiative.

Any decision the Board took with regard to an aspect of misreporting could, contrary to what the staff representative from the Legal Department had said, be applied to cases that had already occurred but had not yet been discovered, Mr. Kiekens noted.

It was hoped that the Board would consider the amendments to the proposed decision that he had offered in his statement, Mr. Kiekens remarked.

Mr. Portugal made the following statement:

This issue of what to do with noncomplying purchases in the case of HIPCs is not an easy issue to decide, because of the collective action problems with other creditors that could arise. To my mind, the staff's suggestion, although it is not a perfect suggestion, seems to be an acceptable and pragmatic way of dealing with the issue.

As I understand the staff's suggestion, the solution that it proposes is the following: if the misreporting incident is discovered before the completion point, then the noncomplying purchase and the disbursement would not be counted as external debt for the purpose of providing debt relief. Of course, this means that the country will still have to pay back those amounts, and if those amounts are large enough, this could even compromise debt sustainability, as the staff recognizes in the statement.

However, on the other hand, as the staff suggested, if the misreporting incident is discovered after the completion point, then as I understand it, the staff's suggestion is that debt relief is provided anyway and no action is taken. As I said, this is not a perfect solution, but I think it is the best solution that we can take under these circumstances, and I am prepared to support it.

Now, Mr. Kiekens in his statement has objected to the second part of the solution, saying that for a repurchase after the completion point, which has been mistakenly disbursed, we should ask for a repurchase, and he suggests that we establish a four-year period after the completion point during which the Fund would be able to ask for the repurchase. His argument is that there is no overriding reason not to ask for that repurchase. I am not inclined to accept Mr. Kiekens's argument, because, if we do that, we could induce all other creditors to do exactly the same, and this could unravel entirely all the HIPC Initiative assistance. We know that one of the basic principles of the HIPC Initiative is equitable burden sharing among creditors. When the HIPC Initiative started, basically by the Fund and the World Bank, it forced all other creditors to extend debt relief to these countries. The reason why the other creditors extended debt relief to these countries was because the Fund and Bank were doing so. Now, if one creditor, in this case the Fund, is entitled to withdraw debt relief after the completion point for whatever reason, even if it is an apparently justified reason as a case of misreporting, then it would be very hard not to accept that every other creditor has exactly this same right. It is possible that the other creditors also made their decisions based on incorrect or inaccurate information, and then if the Fund were entitled to do this, why would the other creditors not be entitled to do this? Therefore, I think Mr. Kiekens's suggestion has this problem and can create this situation. Our current policy already accepts the principle of the statute of limitations, and we now use the period of four years to apply this statute of limitations. Now, to my mind, the staff applies this same principle of statute of limitations in a

> different way. Instead of having a precise period, they have a precise event, which is the completion point, which is an event that has a sort of a time dimension as well, because we know that a period of time would have to elapse between the decision point and the completion point. Consequently, given the complexity of creditor coordination and collective action issues that could arise, I would be prepared to support the staff proposal and not to go along with Mr. Kiekens's suggestion.
>
> I also think that if we accept Mr. Kiekens's suggestion, we could have a rule for the HIPC Initiative cases that would be more demanding than we have for the other cases. His suggestion is that the time limitation would be four years, starting from the completion point. Therefore, for a disbursement, which happens at the same day of the completion point, the period would be the same, four years. However, if there were a disbursement that occurred before the completion point, then, in fact, the time limitation for HIPC initiatives would be longer. It would be the four years from the completion point onward and the period between the disbursement and the completion point. For instance, if there was an installment that was disbursed two years before the completion point, then the statute of limitations, according to Mr. Kiekens's suggestion, would be six years, two years up to the completion point then four years from the completion point onward, which would result in HIPCs having a longer period covered by the statute of limitations than for non-HIPCs. Therefore, because of all these complications, I think the staff's suggestion makes sense, and I think we should accept it. I am not sure that there would be merit in postponing the decision for another day, because it is unlikely that a better solution will be found on this issue. We already postponed it as it was originally a lapse-of-time decision. If we postpone it again there is this issue of Ghana. On the other hand, Ghana is not on the agenda today. Therefore, what we are deciding on is a general policy that will apply to all countries. We cannot take a decision on Ghana today. It would be, I think, bad governance to decide on that. I think we have to decide on the general policy that would apply to all countries, including Ghana, which would not prevent the Board at a later stage, when this new paper is prepared by the staff, to reopen this issue, to discuss it once again, and change the decision that we eventually take today. So, my position would be to support the staff proposal as it is.

Mr. Chatah noted that it would have been preferable to discuss the decision proposed for that day in the context of the broader discussion on information reporting in the context of HIPC Initiative assistance, which the Board would be discussing shortly. That said, the case of Ghana required that the Board act quickly so that Ghana could reach its decision point. However, it appeared that no decision was required in the case of Ghana as the authorities had unilaterally agreed to a lower amount of debt relief in light of the case of misreporting. Consequently, the Board would be able to take a broad look in the near future at the policy relating to information reporting in the context of HIPC Initiative assistance, including the present decision proposed by the staff and the suggestions made by Mr. Portugal.

Consequently, although there was no objection to the decision, Mr. Daïri's proposal seemed more reasonable.

Mr. Kiekens noted that the decision proposed by the staff only related to whether a specific debt occurring as a result of a noncomplying purchase from the GRA or payment from the PRGF should be included in the debt stock on which the debt sustainability analysis of a HIPC was calculated. That decision would change the rules of the HIPC Initiative, which, once changed, would apply uniformly to all countries when they reached their decision points, the first of which would be Ghana.

However, the amendment that he proposed would establish an expectation that a noncomplying purchase would be excluded from the debt to repay the Fund and hence from the total debt stock of the country as long as the Board agreed that there was an expectation to repurchase or repay such a noncomplying purchase or payment, Mr. Kiekens explained. Excluding that amount would require a recalculation of the debt relief to be provided to the country. For example, under the Misreporting Guidelines, the Board could establish an expectation to repurchase noncomplying purchases up to four years after the drawing in question—in effect, it could be somewhat longer as long as the Managing Director had started an investigation into the noncomplying disbursement before the statute of limitations had expired.

A totally separate issue—not on that day's agenda—revolved around the question of what could be done when a country provided erroneous information on key data that determined the debt relief to be provided under the HIPC Initiative, such as the debt stock and export receipts or debt stock and fiscal receipts, Mr. Kiekens commented. In order to avoid the possibility of being able to recalculate the relief forever, a statute of limitations similar to the one the Board had agreed to with regard to misreporting under the GRA or the PRGF could be established. In the case of HIPCs, the statute of limitations should start at the time debt relief was granted, which was the completion point, not when the noncomplying disbursement was made.

Mr. Portugal observed that Mr. Kiekens was in favor of recalculating or adjusting the amount of debt relief even after the completion point in the case of misreporting under the HIPC Initiative. However, Mr. Kiekens only mentioned exports, fiscal receipts, and the debt stock as the data a HIPC could misreport, and then have the amount of debt relief it was entitled to recalculated. However, other information could also be misreported under the HIPC Initiative—possibly with respect to a prior action, or to an aspect not related to the three variables mentioned by Mr. Kiekens—which could require a repurchase or repayment, thus reducing the debt relief to be provided by the Fund and unraveling the debt relief committed by other creditors. It would be very difficult to deny other creditors the right to reduce their provision of debt relief after the completion point if the Fund were to reduce the debt relief because of discovery prior to the completion point that inaccurate information had earlier been provided. For those reasons it was hard to accept that the Fund under such circumstances should ask for a repurchase or repayment and reduce the amount of debt relief it would provide to a HIPC after the completion point.

Mr. Brooke felt that the decision the staff was proposing was unlikely to be changed as a result of a broader discussion of information reporting in the context of HIPC Initiative assistance. Was that the staff's opinion as well?

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael) replied that the proposed decision was consistent with the approach that would be suggested in the upcoming papers on the issue of information reporting in the context of HIPC Initiative assistance. The staff was hoping that the Board would only focus on the specific treatment accorded a country that misreported before reaching its decision point. Consideration of that aspect had been prompted by the case of Ghana. The staff was proposing ways to address cases of misreporting that occurred before the decision point, which were identified either before the decision point or between the decision point and the completion point. The staff suggestion was that if the misreporting were to be discovered before the decision point, the noncomplying disbursement should be removed from the data used to calculate the DSA for a country at its decision point. If it were discovered between the decision point and the completion point, then the noncomplying disbursement should also be removed from the debt stock figures and a readjustment should take place at the time of the completion point, when the DSA could be recalculated. Furthermore, the staff was proposing that no action be taken if the misreporting were to be discovered after the completion point.

Ms. Lundsager noted that the Board was not to decide on HIPC misreporting that day, but rather on how to treat a noncomplying disbursement under the GRA or the PRGF in a member's DSA.

However, it was difficult to understand why any such decision could not apply to HIPCs that had already passed their decision points, Ms. Lundsager continued. The Fund took misreporting very seriously, and Board members had been put on notice of that concern as a result of the broader misreporting Board discussions in 2000. Not subjecting all HIPCs to the same rules would be unfair as the HIPCs approaching their decision points could have fewer resources available to them than HIPCs having already passed the decision point; but if it was later found to have misreported, it could not have the amount of debt relief committed to it readjusted downward, which would increase the amount of relief available to other HIPCs.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael) noted that, to date, no HIPC that had passed its decision point had been found to have misreported any information.

The staff was proposing the possibility of adjusting debt relief at two points; at the time of the decision point if the misreporting were to be discovered before a country reached this stage, or at the completion point if the misreporting were to be discovered after the decision point, the staff representative explained.

A concern had been expressed by Ms. Lundsager was concerned about misreporting that could occur by HIPCs that had already passed their decision points, the staff representative remarked. The decision that staff was proposing would not be applicable to those countries.

If the Board decided to limit the decision only to cases where misreporting had been discovered prior to the decision point and not extend it to cases discovered prior to the completion point, then Ghana would not be subject to any future decision regarding misreporting discovered after the decision point, which would only apply to the HIPCs that had yet to reach their decision points, the staff representative clarified.

Ms. Lundsager asked where it was specified that any decision on misreporting by a HIPC would not be applicable to those HIPCs that had already passed their decision points.

The staff representative from the Legal Department (Mr. Leckow) replied that no such principle was specified in writing anywhere in the Fund's legal system. However, there was a basic legal principle that a rule-making organ could not enact rules that would apply retroactively against the interests of affected parties. In many national legal systems, for example, a legislature could not enact legislation that would hold a party criminally responsible for an act that was committed before the act became a crime. Furthermore, the Fund's policy with regard to misreporting under the GRA or the PRGF did not apply retroactively.

In addition, even though members were aware that the Fund took cases of misreporting very seriously, it could not be said that they were on notice in a manner that would allow the Fund to enact misreporting rules that would apply retroactively to existing commitments of HIPC resources, the staff representative explained. Countries were only aware that the rules governing the Fund's misreporting policy applied to the PRGF and the GRA, not the HIPC Initiative.

Ms. Lundsager asked why a HIPC that had misreported after it had passed the decision point and had to make a repurchase under the PRGF or the GRA would not automatically have the debt it owed to the Fund reduced, which would also reduce the amount of debt relief to which it was entitled in light of a new DSA that would have to be carried out. Such an approach could not be considered a new one that could not be applied retroactively, but rather one that was available under the existing rules.

The staff representative from the Legal Department (Mr. Leckow) replied that the purchase or disbursement would, under existing rules, have also to be treated as debt because, as at the reference date used for the purpose of the DSA, it was debt. The amount only ceased to be debt at a later date when the Fund found a noncomplying purchase or disbursement and the member repaid the relevant amount.

Mr. Daïri remarked that Ghana was willing to go forward with its decision point and would accept the implications of the proposed decision as well as agree not to revisit the issue even if the Board later agreed to a more favorable policy than the one it decided on that day and there was a possibility later of not excluding some of the amounts it had agreed to exclude from its stock of debt.

Mr. Kiekens agreed with the view of the staff representative from the Legal Department that the Fund should apply general principles of law, such as not to apply rules retroactively against the interests of member countries.

The proposed decision before the Board did not relate to misreporting in the context of the HIPC Initiative, Mr. Kiekens explained. Rather, the decision would change the rules of the HIPC Initiative on how to calculate a DSA by permitting the exclusion from a HIPC's debt stock the amounts owed to the Fund that were repaid or repurchased as a result of a case of misreporting, and the revised rule should not be applied retroactively.

However, there was another general principle of law that required that a payment that had been received in error had to be repaid, Mr. Kiekens added. That principle required a country to repurchase a disbursement or repay a payment that had been received as a result of an error in reporting information on which that purchase or payment was made. The Fund had decided that under the Misreporting Guidelines there would be a four-year statute of limitations for starting an investigation into a case of possible misreporting, and that time period would start from the date the purchase or payment was made. A similar approach should be adopted with respect to the misreporting of information provided to obtain relief under the HIPC Initiative, such as information on export receipts and fiscal receipts. Therefore, any HIPC that was determined to have misreported within the statute of limitations, the Board would eventually agree on, would be required to repurchase or repay any amounts it received as a result of that misreporting, regardless of whether the misreporting occurred before the date the Board adopted the new policy, or whether the policy had been explicitly spelled out in a decision because that policy emanated from a general principle of law.

The staff representative from the Legal Department (Mr. Leckow) replied that the Fund operated on the basis of clearly-defined rules that were clearly set out in Fund decisions because the Fund played a unique role that, in many ways, combined those of parliament, judge, jury, advocate, and party to the proceedings. Except in very limited circumstances, the application of the Fund of its Articles and decisions cannot be challenged by members by appeal to a third party such as the International Court of Justice. While the Fund could address those cases through the application of general principles of law, such principles existed outside the Fund's Articles, and decisions and could not be applied unilaterally by the Fund. Rather, any decision taken by the Fund on the basis of general legal principles could be challenged by the relevant member. Consequently, under international law, the Fund would have an obligation to try to resolve such a dispute with the member amicably, for example, through mediation, conciliation, or, ultimately, arbitration. While the Fund could try to base its policies on general principles of law rather than an interpretation of the Articles or through Board decisions, such an approach would be very different from the way the Fund had operated in the past. The Fund could not operate unilaterally in the manner it had when it was operating within the confines of the Articles, and the Fund's decisions.

Mr. Nijsse made the following statement:

I have read the staff report and Mr. Kiekens's statement with much interest. It is unfortunate that more than a year after our last discussion on this issue the current proposed decision addresses only part of the problem connected to misreporting and the HIPC Initiative. Although I do not agree with Mr. Kiekens that debt relief should be revoked if misreporting is discovered after the completion point, I would be concerned if such misreporting would have no consequences at all. Therefore, something should be added to the proposed decision or introduced in a separate decision that can be discussed in the Board soon about alternative sanctions resulting from unjustified debt relief being granted from intentional misreporting that is discovered after the completion point. A sanction mechanism could provide adequate incentives to prevent such cases from emerging. Furthermore, not attaching any sanctions to debt relief provided on the basis of false information could result in reduced public support in creditor countries for the HIPC Initiative.

Most cases of misreporting in the context of the HIPC Initiative will be unintentional and can be handled with a waiver. If there is clear proof of intentional misreporting, sanctions should be imposed as is the case with GRA or PRGF programs. If the question is what sanctions after the completion point would be appropriate, requiring the country to return debt relief might not only raise uncertainty about the irrevocability of debt relief, but also might put the country concerned in serious financial problems. As Mr. Portugal said, all other creditors might revoke the debt relief they were to provide as well. Sanctions for misreporting after the completion point might range from a public reprimand to reduction in financing and a stronger domestic adjustment requirement under an ongoing PRGF-supported program. Preferably the modalities of such sanctions should be considered on a case-by-case basis depending on the severity of the misreporting case.

With regard to cases of misreporting discovered before the completion point, I can agree with the staff proposal to recalculate and adjust the debt relief to be provided. However, the reduction in debt relief should not only be carried out by the Fund, but should also lead to a proportionate reduction of debt relief to be provided by all relevant creditors.

With regard to Ghana and Mr. Daïri's point, I think that if we reach agreement on the proposed decision today we can apply it to Ghana. It will otherwise be very difficult to create special rules for Ghana, because there will be a certain precedent established.

Mr. Daïri agreed that the Board was not discussing an issue of misreporting under the HIPC Initiative, but rather the issue of how to treat a repurchase or repayment of a noncomplying disbursement when doing a DSA for a country that was about to reach its decision point.

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

> I would like to comment on some of the points made by Mr. Kiekens and Mr. Nijsse.
>
> The staff recognizes that at this stage the discussion only concerns how to implement the Misreporting Guidelines in the context of the debt sustainability analysis. In that context, the proposal before you today is limited to how we can deal with noncomplying disbursements discovered between the period when the debt sustainability analysis (DSA) underlying the decision point is first carried out and the period when the debt sustainability analysis is carried out at the time of the completion point. The staff took this approach because the Fund operates based on very explicit rules, and the staff wanted to be very clear on what the DSA calculations would be based on. We needed to do that not only for clarity, but also in order to have clear understandings with our colleagues from the World Bank, and to provide clarity to other creditors as to how we do the debt sustainability analysis, given the importance that everybody attaches to that and the visibility among civil society.
>
> What we are proposing is simply a correction of a mistake. If the Fund disbursed more money than it would have done if all the correct information had been available to it, it would only make sense to correct that error. The staff prefers to do this with a formal, clear rule that applies up to the decision point, where there will be an immediate adjustment, and if the error is discovered after the decision point, up to the time of the completion point, with an adjustment made at that point. In all these cases, whatever the Fund does will affect the overall debt position of the country and will have implications for other creditors. Therefore, in response to the point that Mr. Nijsse made regarding how other creditors would be affected by the Fund's action, I would say that they would most likely be positively affected, because the common reduction factor that would be needed to bring the debt down to the debt sustainability level will be lower. The same logic applies to the calculations carried out at the completion point.
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> The area where we draw a difference from Mr. Kiekens is that there are many other areas of data where possible implications of misreporting would apply in the context of the HIPC Initiative, such as data on exports, GDP, government revenue, or even debt, as changes to those data would lead to a possible reduction in debt relief. These issues will be covered in one of the upcoming papers on information reporting in the context of the HIPC

Initiative that will be issued soon. Similarly, there will be issues related to misreporting with regard to the record of performance on which the staff, management, and the Board make a judgment as to whether either at the decision point the country had a reasonably good record of performance and also has a good record by the time it reaches the completion point. These issues will also be addressed in one of the upcoming papers on information reporting in the context of the HIPC Initiative. Those papers will also address the issue of retroactivity.

I would like to clarify why we say that after the completion point the Fund will not make any further adjustments. In the view of the staff, there is a need to bring the HIPC Initiative to some finality. The staff certainly does not want to let a noncomplying disbursement go unaddressed as that might give the wrong incentive, particularly if misreporting were deliberate. There has so far not been a case of deliberate misreporting by a HIPC. Most of the revisions to debt data have so far been related to data provided by creditors. There has also been no case so far of revisions to export data, GDP data, or anything related to provision of data by the authorities. In fact, the adjustments have been upwards in light of the revised data. The upcoming papers will address the possibility of adjusting downward, but not only because of debt data, but also because of changes in macroeconomic variables.

Returning to the issue of addressing misreporting that is discovered after the completion point, we feel that if there is no finality to the HIPC Initiative process and a country passes the completion point, but has not passed the period covered under a statute of limitations—for example, four years—then the country that is receiving assistance will not be certain that the HIPC Initiative process is over until the period covered by the statute of limitations expires. Other creditors may take a wait-and-see attitude as well. We have already had several cases of non-Paris Club official and commercial creditors that are participating very little, if at all, in the HIPC Initiative. If we give them another two or three or four years' time to procrastinate, that would affect not only the amount of debt relief a country would receive, but also the public perception that the HIPC Initiative, and the Fund would be on the receiving end of significant public criticism.

We have to weigh the costs and benefits of the two options. Obviously, we do not want to be taken for a ride, but at the same time we have to weigh the broader good of bringing this issue to finality. If a country misreported, there is a possibility of a granting a waiver and a possibility of asking the country to take other actions possibly to address that. If we adopt a purely legalistic approach, that will open up the HIPC Initiative to more criticism, which is not an option that the staff recommends. Obviously, in the end it is for the Board to decide on this issue.

> I want to draw a distinction between the various concerns and other arguments that the Board may wish to reflect upon. Our recommendations and the proposed decisions reflect the view that the need to bring the HIPC Initiative to finality overrides other concerns that may exist. This does not mean that the Board would have no room to revisit the past and reexamine a case of misreporting and how it could affect the calculation of the debt sustainability analysis. As the staff's proposal with regard to a noncomplying disbursement can be applied to the debt not only up to the decision point, but also at the time of the completion point, there is time for the Board to discover a case of misreporting. This period will vary depending on how fast a country needs to meet the completion point triggers, but in practice this time ranges from one year to two years or even longer. We therefore have some time to investigate if there is any evidence that a possible case of misreporting occurred prior to the decision point. Other possibilities relating to misreporting will be discussed in the upcoming papers, which will be unrelated to noncomplying disbursements and how they enter the debt sustainability analysis. However, the issue today regards noncomplying disbursements and the DSA, and the staff's proposal gives the Fund some time after the decision point to revisit the past and investigate if there was any misreporting, but the overriding need to bring the HIPC Initiative to finality motivates the suggestion by the staff and management not to revise the amount of debt relief the Fund will provide after a country reaches the completion point.

Mr. Kiekens agreed that there was a need to bring finality to debt relief provided under the HIPC Initiative. That was the rationale behind the proposal to introduce some kind of statute of limitations. However, whereas the staff was in favor of limiting the statute of limitations to the completion point, it was preferable to have it cover a period of fours years from the date of the purchase or payment determined to be noncomplying, which would also be consistent with the misreporting policy under the GRA and the PRGF.

The staff representative from the Policy Development and Review Department had also mentioned the issue of fairness, Mr. Kiekens noted. However, it was critical that the Board as trustee of the HIPC Trust managed the use of the resources committed to the Trust properly, and therefore it would need to protect the Trust from the consequences of any misreporting.

Mr. Portugal agreed with the staff representative from the Policy Development and Review Department that the HIPC Initiative needed to have some finality associated with it, which was why it would be inappropriate to revise the amount of debt relief for a HIPC after it had passed the completion point. Revising the amount of debt relief to be provided by the Fund after the completion point could also allow other creditors to do the same. Furthermore, reducing the amount of debt relief could cause a HIPC to reduce the amount of resources it had initially targeted for social expenditure. Therefore, the approach suggested by the staff appeared to be the most appropriate in light of all the concerns that had been expressed on both sides of the issue.

It was not necessary to apply the four-year rule with regard to a statute of limitations for HIPC misreporting cases, Mr. Portugal remarked. It would be more appropriate in light of the HIPC Initiative framework to set the completion point as the deadline for the statute of limitations. That would allow more than enough time to pass, as it took countries a significant amount of time to build up the track record of good policy performance needed to reach the decision point and later the completion point. Furthermore, any misreporting discovered after the completion point was passed would obviously affect relations between the Fund and the HIPC as well as the Fund's decisions on future Fund financial assistance for that HIPC or on other issues where the Fund could exert some leverage. There would be too many possible negative consequences for extending the statute of limitations past the completion point, particularly with regard to the issue of how other creditors would react.

Ms. Lundsager asked the staff to present some proposals in the upcoming papers on both how the Fund could create the proper incentives for discouraging misreporting prior to the completion point and what options could be available to the Fund if a case of misreporting were to be discovered after the completion point. The Fund's fiduciary responsibility required that it protect the resources entrusted to it as the trustee of the limited resources in the HIPC Trust.

Other creditors were very involved with the whole HIPC Initiative process, Ms. Lundsager noted. Therefore, any action by the Fund that resulted from a case of misreporting by a HIPC would have ramifications for those creditors as well. What was the Bank's view with regard to the staff's proposal of how to treat cases of noncomplying purchases for a country that had yet to reach its decision point?

The Acting Chair (Ms. Krueger) observed that most Directors supported the proposed decision, although some also supported going further along the lines of Mr. Kiekens's proposal. The Board should first express a view with regard to Mr. Kiekens's proposal before expressing a view on the proposed decision.

Mr. Brooke made the following statement:

> We were one of the Directors who supported this issue being discussed. I think the complexity of this discussion highlights one reason why it was worthwhile bringing it to the Board.
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> Another reason why we wanted to see this issue discussed at the Board was that which was just raised by Ms. Lundsager; we were concerned from the initial staff paper that there was a perception that this was a unilateral action being taken by the Fund, and given the importance of the HIPC Initiative as an initiative that is supported by the World Bank, the Fund, and all the bilateral creditors, we wanted to have some reassurance from the staff that all parties were signing up to the process and were content with the staff's proposals.

I am grateful to the extra statement the staff issued, which helped to clarify things, but any further thoughts in response to Ms. Lundsager's questions would be appreciated.

The only other points I would like to raise at this stage are that we strongly agree with the staff and with other Directors on the principle that the Fund needs to send strong signals about misreporting in all of its dimensions, whether it relates to the PRGF, the HIPC Initiative, or to other Fund programs. We can broadly agree with the staff proposal as set out.

Having said that, we have a lot of sympathy with the points raised by Mr. Portugal and Mr. Nijsse. We certainly would not support Mr. Kiekens's idea that any discovery of misreporting after the completion point result in the clawing back of debt relief. Our feeling very much is that the fundamental principle of the HIPC Initiative is its irrevocability after the completion point, as the staff representative from the Policy Development and Review Department was just describing. We would very much support the comments that he made earlier on. This sort of irrevocability closes the door behind a very complex set of bilateral and multilateral agreements. If we were even to open that door a small crack, I think it could unwind the process with really quite adverse consequences. Therefore, when we come around to have a broader discussion of this—there are a number of people who have unease about the completion point aspect and closing the door—I think we might be amenable to Mr. Nijsse's suggestion of having some sort of censure motion, but we would not want to see any element of the debt forgiveness being unwound after the completion point. We definitely think that is the final element that should be underlying this whole process.

Mr. Alosaimi made the following statement:

The proposed amendment to the HIPC Trust Instrument addresses an important issue. A misreporting discovered in retrospect could indeed imply not only a Fund repurchase expectation, but also an unintended component in the overall debt relief. Clearly, the discovery requires appropriate rectification to avoid rewarding the misreporting member. At the same time, it is important to provide HIPC countries and investors assurances regarding the finality of the process that culminates with an exit to debt sustainability at the completion point. Reopening the issue of debt relief after the completion point could create uncertainty and undermine confidence in the initiative. Therefore, like Mr. Portugal and others, I can go along with the staff's proposal regarding the treatment of noncomplying purchases in the debt sustainability analysis.

Mr. Boitreaud made the following statement:

The issue of what to do after the completion point is really a thorny one, and the points made by the staff, Mr. Portugal, and Mr. Brooke are very convincing. However, at the same time one fears that doing nothing after the completion point could lead to an unfair treatment among HIPCs. For that reason I am in favor of Mr. Daïri's proposal, which is to leave the question of what happens after the completion point until the broader discussion we are to have in March.

However, I would like to ask the staff that if in March we make a decision regarding what should be done after the completion point, will that apply to Ghana as well even though it would have reached its decision point prior to that decision?

Mr. Bischofberger made the following statement:

The resources devoted to the HIPC Initiative are limited. We are in strong favor of measures aimed at ensuring a proper allocation of these scarce resources.

If a country receives means from the Fund that it is not entitled to, it has to pay back these amounts according to our guidelines. Moreover, such noncomplying disbursements or purchases should not result in an unjustified amount of debt forgiveness. This would be against the spirit of the Enhanced HIPC Initiative. I would also undermine the goodwill of the donor countries of the HIPC Trust Fund. In addition, it would be unfair for those HIPCs that adhered to their programs and played the game according to the rules.

We are, therefore, pleased by staff's proposal to address this issue. We are also pleased by staff's clarification that the implementation of the proposal could give rise to a reduction in debt relief from all creditors. However, given the possible far-reaching implications of a decision today we would have appreciated a more in-depth preparation of this sensitive issue.

Let me reiterate that we welcome staff's proposal as a step in the right direction, and we are prepared to support it.

However, we also have some sympathy with Mr. Kiekens's concerns that after a country has passed the completion point no recalculations or adjustment of the HIPC Initiative assistance is possible according to the proposal. Such a cut-off date could indeed set wrong incentives. On the other hand, at a certain point of time one has to draw the line. We are therefore interested in staff's reaction to Mr. Kiekens's proposal of a four-year limit, and I appreciate the staff's earlier clarifications in that respect.

However, if such a time limit is not feasible we would to ask the staff whether it sees a possibility for alternative punitive actions after the completion point for those countries that benefited from unjustified debt relief.

Regarding the retroactivity of any decision taken today, it might be difficult to strike a proper balance between a desirable equal treatment of all HIPCs, including those that have already passed their decision points and general legal constraints with respect to retroactivity.

Finally, I would appreciate if the staff could also comment on the possible implications of today's decision on the oncoming considerations regarding Misreporting in the Context of HIPC Initiative Assistance.

Mr. Yanase made the following statement:

This issue of misreporting and its impact on the debt sustainability analysis is indeed a very important issue, and the discussion so far has been very interesting and very stimulating.

However, it seems that, except with regard to how we deal with the issue after the completion point, there seems to be a sort of agreement as to what we should do, which is also in accordance with the staff proposal. However, there seems to be a strong difference in the Board about what we should do if the repurchase or repayment expectation arises after the completion point. In this matter, I have some sympathy for Mr. Kiekens's view, and I share the views of Ms. Lundsager and Mr. Nijsse that there must be some kind of measure to provide an incentive to avoid misreporting. I certainly understand that there must be some kind of finality regarding the HIPC Initiative, but I also have some sympathy for Mr. Kiekens's view that the finality of the HIPC Initiative might not be need to be set as the time of the completion point.

I welcome the supplementary statement by the staff and the oral explanation. However, I do not feel enough information has been provided so far, and of course as this issue is very important, what we are going to decide must also be consulted with my authorities as they are one of the biggest creditors and contributors to the HIPC Initiative. Therefore, my reaction is similar to what Ms. Lundsager and what Mr. Nijsse said, which is to postpone the decision on what we are going to do with regard to misreporting that occurs after the completion point. Provided that we will revisit this issue in the March discussion, I can agree with the staff proposal.

Mr. Padoan made the following statement:

We have always attached paramount importance to enhancing the credibility, the effectiveness, and the success of the HIPC Initiative as well as deeply regretting any case relating to noncomplying purchases and disbursements.

We support the argument put forward by the staff that the DSA should take into account whether the country in question is expected to make an early repurchase under the Fund's Misreporting Guidelines. Mr. Kiekens in his statement points out that a recalculation or a readjustment should be made also in the case where a country has already reached the Completion Point. Otherwise, a case of misreporting would be treated in a totally different way according to whether the Fund finds out about such a case before or after the Completion Point. We agree, as a general principle, that the same case of misreporting should lead to the same sanction or course of action.

On the other hand we have to acknowledge that the credibility of the Initiative is based on the firm principle that any relief granted at the Completion Point is irrevocable. We agree with the staff that the HIPC Initiative must be finalized. Allowing for a recalculation after the Completion Point could weaken the process and, as a matter of fact, would stretch the deadline about when the effective Completion Point is reached.

It is not easy to strike a balance between these two approaches equally right on their own grounds.

We agree with the proposed decisions as drafted in the staff paper but our discussion clearly signals the difficulties in implementing the HIPC Initiative. To say the least, the DSA should be carried out even more carefully in connection wit possible cases of misreporting.

We look forward to the upcoming broader discussion and, as Ms Lundsager and others, we would like to consider concrete proposals from the staff to deal with cases of misreporting after the Completion Point.

Mr. Andersen made the following statement:

I can also agree to the staff's proposal, but I also think Mr. Kiekens's concerns are valid and I think I can associate our position with the comments made by Mr. Nijsse. I was wondering if we, by approving the proposed decision and having a summing up of this discussion as well, can make sure that the message gets through that misreporting discovered after the completion point should have some consequences.

When I look at the staff paper, the proposed decision certainly looks fine. What disturbs me a little bit is the one sentence at the end of paragraph 3 that says that no recalculation or adjustment would be made after the completion point. I was wondering whether this sentence is really necessary, or could we perhaps take into account the concerns raised by many around this table in the summing up?

Mr. Vermaeten made the following statement:

Just very briefly, I think this is a practical issue between balancing a couple of principles, and overall we support the staff's proposal as well as the comments made by Mr. Portugal, Mr. Brooke, and Mr. Nijsse.

Mr. Zurbrügg made the following statement:

We could only go along with the proposed decision of the staff if it were to take into account Mr. Kiekens's points. There are two main arguments for this position. The first point is that the statute of limitations with regard to HIPC Initiative cases should be comparable to processes we already have in this institution. It would be dangerous to define an event that is variable in time depending on the case, and it would therefore be better to define a period for the statute of limitations that would be identical for all countries.

The second point relates to the concern over the effect this decision could have in terms of unraveling participation in the HIPC Initiative. However, if this decision is clearly communicated and if the impact on all other creditors would be downward in terms of their participation—we assume that coming back to a country after it has passed the completion point would be highly exceptional—that should partly mitigate the concern put forward by colleagues.

Mr. Lissovolik made the following statement:

I welcome the staff proposal, but I believe that we will need to have a broader discussion on how to treat misreporting after the completion point. The need for finality does not necessarily override the concerns associated with the implications of misreporting. Such concerns with respect to country incentives have been recognized today by the staff and by Mr. Portugal, which does suggest that the issue posed by Mr. Kiekens is important.

Mr. Usman made the following statement:

We support the proposed decisions by the staff. We also identify with the positions of Mr. Portugal and Mr. Nijsse. I think the key issues should be finality and irrevocability. While we accept that misreporting should be penalized, we must find, I think, a halfway position where this can be done without necessarily leaving the whole matter open ended and creating additional problems.

Mr. Garner made the following statement:

We agree that the issue of misreporting is a delicate subject that requires more profound analysis from a technical and legal perspective. For this reason we welcome the coming paper on information reporting in the context of HIPC Initiative assistance. We believe that any modification to the present proposal has possible implications that we are not aware of at this moment. Therefore, we believe that there will be widespread support for the proposal as it is now, but we concur that this is an issue that requires further analysis by the Board.

Mr. Daïri made the following statement:

In view of the discussion, we also attach high importance to the irrevocability of debt relief after the completion point and we can support the proposed decision.

Mrs. Kabedi-Mbuyi made the following statement:

I think at this stage we would like to associate ourselves with the views presented by Mr. Portugal and Mr. Brooke. The explanations by the staff representative from the Policy Development and Review Department were very convincing.

I would like to pick up on two elements. One is the finality of the HIPC Initiative. The second is the risk of a wait-and-see attitude that can be triggered by an amendment to the decision as proposed by the staff. The reason why these issues are important to us is that HIPCs are increasingly embarking on preparing and working with medium-term budget frameworks, and in the context of such frameworks the debt relief under the HIPC Initiative is an important component. Therefore, raising the risk of other creditors possibly adopting a wait-and-see attitude would create uncertainties and could have important risks in terms of the macroeconomic framework or its sustainability for HIPCs. Moreover, I am sure that in the March discussion the staff will come forward with proposals in terms of defining deterrents to countries engaging in misreporting in the context of the HIPC Initiative.

Mr. Maino made the following statement:

We welcome the finalized overall assessments and key action plans of public expenditure management (PEM) systems agreed with HIPC authorities. The country-specific information in the background paper and the results presented help to address the risks embedded in this initiative and facilitate the immediate tracking of poverty reducing public spending in HIPCs. The conclusions in the accompanying document points to a generally weak state of PEM systems in heavily indebted poor countries. This only reaffirms, in our view, the need not only for political will, but also for greater financial and technical assistance resources to narrow the institutional and administrative gap that breeds insufficient accountability and efficiency in budgetary management.

We reiterate our support for efforts to improve the institutional capacity for budget formulation, execution, and reporting, as well as for implementation of good policies, including judicious tracking of HIPC assistance to facilitate progress in poverty alleviation. It is difficult to conceive meaningful poverty reduction strategies in HIPCs without adequate international relief, commensurate with their capacity constraints for managing budgetary resources.

Notwithstanding the critical role of country ownership over the policy content, there is ample scope for improved coordination and collaboration by the international community in the development of more comprehensive budgetary systems, as part of an ongoing process of structural reform and capacity building. We welcome the close collaboration between the World Bank and the Fund staffs and country authorities in the review of the tracking process. However, for this effort to bear fruit, i.e., the timely production of the requisite data to monitor progress in poverty reduction, tracking of budgeted and actual outlays should involve all poverty-reduction related spending, including “virtual funds” and not just that covered by HIPC resources. This underscores the need for realism in the formulation and sequencing of action plans to be included in PRSPs, to achieve real efficiency gains from public spending and reinforce ownership.

More strategic implementation and effective allocation of assistance, in particular donor-financed expenditures, inevitably involves a learning curve not just for the recipient countries but also for the international community. From a fiduciary perspective donors rightly need assurances that resources released under the HIPC initiative will be allocated to poverty reduction. On the other hand, recipient governments need to allocate and implement public expenditures consistently with their respective poverty-reduction strategies in generally volatile external and domestic conditions, which could have a major impact on their macroeconomic performance. Safeguarding HIPC resources and the reform process, therefore, requires that donors, recipient countries, and international financial institutions complement each other in the timely provision of financial and technical assistance. It is in this context, that we welcome the HIPC action plans aimed at introducing short- and medium-term improvements to their PEM systems in light of the agreed preliminary assessments. It is in this sense that the identification of additional assistance in support of country action plans assumes particular relevance.

We find merit in the fact that action plans are intended to complement and not substitute for the existing set of programs and instruments. Conceptually, we concur with the short-term actions to strengthen commitment controls and routine reconciliation of government accounts. The staff notes that “bridging mechanisms” have been advanced by “tagging” certain budget line items and by providing a subsequent virtual poverty fund. In this respect, we attach importance to concomitantly advancing output indicators to gauge dynamically the social and economic impact of such spending. This suggests the desirability of a case-by-case approach for expenditure reporting.

Notwithstanding efforts to gather and report the best available information contained in paragraph 26 of the staff paper relating to short-term measures to strengthen PEMs, we consider that these actions should advance within medium- to longer-term strategies. The role of legislative and regulatory frameworks is critical to strengthen the ability to implement and enforce the economic and social objectives of budget expenditures and more generally build up confidence in the budget process.

We generally endorse the approach for strengthening PEM systems and macro-fiscal management particularly in PRGF-supported programs when assistance is being provided in the form of general budget support. While we concur with the staff on the desirability of reinforcing MTEFs and budget classification systems to improve budget preparation and execution, the starting position of precarious budgetary systems in heavily indebted poor countries justifies resort to multi-year projections as a second best alternative.

The close cooperation between the Fund and the World Bank staffs is deemed essential to avoid duplication as well as gaps in assistance. Both institutions should work from a clear “a priori” identification of responsibilities. Their joint work should help focus the assistance of MDBs and bilateral donors on improving budgetary effectiveness. Given that assessments are conducted by different mission teams, it is vital to maintain smooth communications and a proper compiling effort. The availability of adequate MDB financing to build-up capacity to track spending under the enhanced initiative remains our principal concern and should be addressed flexibly so as to facilitate achievement of macroeconomic targets agreed with the Fund. We also strongly support the provision of technical assistance in order to increase budgetary effectiveness. The Fund and the World Bank should continue to encourage HIPCs to further improve their PEM systems and to link the process to an actual estimate of the potential need for Fund and World Bank technical assistance missions and resident experts.

We support the publication of the main staff paper SM/02/30 to provide a roadmap and incentives for faster reform and implementation. The Fund should, however, also be prepared to play a supporting role, including on reporting of progress in implementing action plans. This communicational procedure would ensure that each program, be it formal or staff monitored, reflects the circumstances and priorities of the HIPC country concerned.

In sum, we encourage the Fund and the Bank to continue to take a pragmatic and complementary approach to build up on existing PEM systems in HIPCs and improve institutional capacity to facilitate implementation of more robust MTEFs.

Mr. Chatah made the following statement:

I have spoken before in support of Mr. Daïri's earlier suggestion. Now that the Board has spoken, let me stress that we too feel strongly that purchases resulting from misreporting need to be reserved. This is an important element of the Fund's approach. We had felt that there are considerations that argue in different directions. We also referred to the potential moral hazard in creating incentives for postponing certain revelations of misreporting—and I do not want to imply that this is common or likely to happen—until past the decision point. On the other hand, some kind of closure is nonetheless important for the reasons already mentioned. That is why we had felt earlier that maybe a broader discussion later on would be more informed. We are prepared however to go with the decision as drafted.

Ms. Davidson made the following statement:

We can support the staff proposal. However, we feel that there is a need to come back to how we handle some of these completion point concerns.

Mr. Brooke expressed concern over the possible implications the Fund's actions would have for other creditors. For example, already in the case of Ghana some creditors were using the case of misreporting as a possible reason not to provide debt relief. Was the staff aware of other examples of such actions on the part of creditors?

Would it be possible for the staff to exercise greater due diligence with regard to information provided for a DSA, Mr. Brooke asked.

Mr. Wei associate his views with those of Mr. Portugal, supporting the proposed decision as it stood.

Mr. Kiekens noted that, contrary to what some other speakers had said, his proposal for how to treat misreporting discovered after the completion point would retain the sense of finality associated with the Initiative. The only disagreement between the staff's proposal and his related to the statute of limitations.

A DSA could be recalculated with little difficulty as long as the proper arrangements were in place, Mr. Kiekens remarked.

It appeared that the Board generally supported the proposed decision, and that there was not enough support for his proposal, Mr. Kiekens observed.

What options would be available to the Board if the Managing Director started an investigation into a possible case of misreporting by a HIPC before it reached the completion point, but the Board determination that misreporting had occurred took place after the HIPC had passed the completion point? Mr. Kiekens asked. It would be odd if the Board were to approve a completion point being at the same time aware of an ongoing misreporting investigation.

Mr. Chatah had made a good point that HIPCs could have an incentive not to reveal an incident of misreporting until after the completion point, Mr. Kiekens commented. That was an important point as the resources provided to a HIPC were not in the form of a loan that eventually would have to be repaid but rather in the form of debt relief.

The arguments in favor of having some kind of finality with the HIPC Initiative process were not relevant in the case where the reduction in the amount of the commitment as a result of a recalculated DSA exceeded the commitment remaining to be disbursed at the completion point, because the completion point would still have to be reached, Mr. Kiekens said. Furthermore, treating interim assistance as final could be dangerous as there had been cases where the Fund had provided substantial interim assistance and where the time between the decision and completion points had also been reduced, which would have implications for any statute of limitations.

Mr. Djojosubroto said that he supported the proposed decision, and agreed with the points raised by Mr. Portugal.

Mr. Portugal clarified that he had mistakenly characterized Mr. Kiekens's proposal as being one that would not close the issue of how long a HIPC could be subject to action as a result of prior misreporting.

Mr. Gauba made the following statement:

> We support the decision proposed by the staff that the completion point should be the last cutoff for purposes of recalculation and adjustment. However, we feel that Mr. Kiekens raises a serious issue, and we should not end up in a situation where misreporting is not visited by any adverse consequences. For this purpose, the Board should discuss this matter separately and explore other possibilities.

The staff representative from the World Bank (Mr. Kolster), in response to questions and comments from Executive Directors, made the following statement:

> I think that it is fair to say that we see eye-to-eye on the issues that are being presented in the short paper here, and we are in fact finalizing the joint paper, which you will hopefully be able to consider in March, and which the Bank will consider in early April.

I think Ms. Lundsager asked a question as to how the World Bank as one of the major creditors looks at both the cutoff date being the completion point and the Fund's proposal to claw back an erroneously disbursed tranche at—or prior to the time of—the decision point, which is the case with respect to Ghana. As the Fund staff has suggested here, the whole process is very transparent, and it is very fair in the sense that all creditors in the case of a reduction or claw back of an erroneously disbursed tranche will share a smaller burden, as the DSA would be recalculated based on a revised debt stock from which the noncomplying disbursement would be excluded. Therefore, all the creditors would benefit from that.

As to the question of the cutoff date, I do not want to repeat what the staff and many of you around the table have said already, but on our side it is very clear that the notion of finality at the completion point has been an integral part of the HIPC Debt Initiative from the very beginning when it was approved by both the Fund and the World Bank in September 1996. The irrevocable nature of debt relief at the completion point was also emphasized in the enhancement of 1999. There are of course moral hazard issues, however I would also suggest that this issue is one that the Development Committee should address because it goes to the core of the HIPC Debt Initiative and the framework for it.

To sum up, we on Bank side are 100 percent in line with the Fund staff on the issues that you have discussed today.

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

Let me first start by noting that the HIPC Initiative is a framework that is already a policy of the Fund, the World Bank, and the international community. As part of that broad framework, there is already broad acceptance of the issue of irrevocability and finality of the decisions made by the completion point. Any suggestion of changing that or moving the goal posts would need to be put in the context that we are changing the rules of the framework again. However, that is something you may wish to keep in mind. When the Enhanced HIPC Initiative was agreed to 1999, the time needed to reach the completion point was made more flexible through the adoption of floating completion point triggers. The intention was to shorten the period between the decision point and the completion point. Any decision now to allow for a period for a statute of limitations or for other reasons, however well intended in terms of protecting the support among the creditor countries for the HIPC Initiative, would go against that principle that has already been accepted. Therefore, I would wish to highlight that you will need to keep that in mind in any decisions that you may take.

We always have the possibility of going from the narrow issue of misreporting to broader issues of misreporting, instead of only limiting the discussion to the case of noncomplying disbursements and the adjustment of the DSA. The broader issues of misreporting would revolve around the observance of the triggers or the track record, and perhaps this is unavoidable. However, I do not want to preempt the discussion of the upcoming papers.

I have already mentioned the two considerations we had on why the staff decided on the proposal that is before you. However, there is one other aspect of it that I regret I did not mention earlier. That issue revolves around why the staff is more or less proposing to override the four-year statute of limitations that exists with regard to misreporting cases under the GRA and the PRGF, and is the staff proposing this because of the finality issue or because of some special element that is associated with the HIPC Initiative? The staff believes that the Board should take into consideration something special that is connected to the HIPC Initiative. That is, under the HIPC Initiative framework we are not giving money to a country to use for reserves or to cover its overall balance of payments deficit, which would be similar to the typical Fund balance of payments support. We are giving credit into an escrow account and from the viewpoint of the Fund this credit is to be used to pay part of the debt service payments due to the Fund, and when the obligations to the Fund come due, this money is used, if you like in an accounting sense, to repay the Fund. Therefore—because being able to adjust the amount of debt relief before the decision point is something that I understand everybody agrees on—the difficulties arise only when we move from the decision point to the completion point, and then after the completion point.

During the period between the decision point and the completion point, on the basis of a good track record of performance, the Fund provides on an annual basis interim assistance that is put in an escrow account operated by the Fund as a trustee, and is released in line with the obligations falling due to the Fund. It is limited to a portion of the payments due. Therefore, these funds are used in an accounting sense depending on the schedule of repayments to the Fund. Assuming that during this period we discover that misreporting occurred and we want to get all our money back, in the case of the HIPC Initiative it is would be awkward to try to get our money back because some of the money has already been paid to the Fund. Any decision that is taken to ask a country to repay the Fund will need to take into account what is said in footnote 5 of the staff paper, which is that any reduction in the amount of the commitment could not exceed the amount of the commitment remaining to be disbursed at the completion point. Otherwise, we will be asking a country to return funds that have already been used to cover debt service due to the Fund, while its obligation to the Fund will be intact. It is in this sense that the HIPC Initiative is of a different nature, which raises public relations and other concerns you may wish to take into account. From the point of view of the staff, we are suggesting that any claw back be limited to the uncommitted resources because it would be like asking a stone for blood. To the extent a country has already used the money, at a time when by the very nature of being a HIPC it has debt service difficulties and cash flow problems, a request for the country to return the full amount of debt relief provided by the Fund without reducing its obligations to the Fund, could result in a major public relations issue.

The suggestion the staff is making is that any claw back during the period between the decision point and the completion point be limited to the nondisbursed resources in the Umbrella Account. For the same reason, this issue would apply with even more force after the completion point, because by then, assuming a country reaches the completion point. This is one further argument that motivates the staff's position that we need to be more careful and probably put more weight on the finality argument and the special nature of the resources that we are dealing with.

Having said that, Ms. Lundsager made some very valid comments as to how we can be sure we do not give the wrong incentives to countries. As you will see from the broader paper, the staff will need to be even more vigilant and more careful in verifying all the facts and figures as we get to the decision point and as we get closer to the completion point in order to ensure that there is no misreporting. Moreover, misreporting is not always brought to the attention of the Fund by the authorities of a country. Certainly we have cases such as the latest misreporting by Ghana where the authorities came forward. However, in a previous case of misreporting by Ghana, it was the staff that discovered the misreporting. In other cases of misreporting it is other creditors or other interested parties that brought some facts and information to the staff, and then the staff initiated the process. Therefore, the possible risk of giving the wrong incentives, as Mr. Chatah said, is not as great as it may appear.

What are the measures, sanctions, incentives, or, if you like, we have to encourage countries to more or less be as transparent, open, and truthful in stating the facts? The most basic issue is that these countries continue to have major financing needs, even after the completion point. It would be hardly in their advantage to antagonize the donor community by appearing to be committing fraud. Not only would the Fund be justified in saying, well, we need to probably take more time to consider whether we can renew any program we have with the country in question, which may delay the completion point and may delay formal support of a program after the completion point, but also the donor community has to draw its own conclusions in deciding the amount of financial assistance for a country. It is not entirely a costless exercise for countries to misreport to a level that is considered serious enough not to warrant a waiver from the Board. There might be possibilities of innocent mistakes where the Board may grant a

> waiver. However, in serious cases of deliberate distortion of facts, it would be against the interest of the country to antagonize the international community given the financing needs that it would continue to have, (especially for concessional resources). At the same time, the Fund itself would be reluctant to approve a formal program for a country in such circumstances; given the existing operational guidelines in the Bank, the provision of assistance from the Bank would also be difficult in the absence of a formal program with the Fund. Moreover, if the Fund and the Bank do not endorse a PRSP, donors may not provide the support that was contingent on the BWIs' approval of the PRSP. In addition to that, Article VIII, Section 5 pertaining to the provision of data related to exports, GDP, and other information a country needs to provide in the context of surveillance, allows for sanctions in cases of misreporting, which in the extreme include suspension of the use of resources or suspension of voting rights. There is no precedent for that yet. However, there have been one or two recent cases where the Board discussed this, including the possibility of a declaration of noncooperation. Furthermore, given the participatory nature of the PRSP process, the accountability of the government vis-à-vis domestic stakeholders would hopefully help avoid extreme cases of deliberate misreporting.
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> However, even if we ignore all of this and consider the technical aspects of how to implement a framework as proposed by Mr. Kiekens, what are the kinds of sanctions the Fund can impose if the completion point has passed and resources have already been used to repay the Fund and a case of misreporting is discovered? It is always possible to grant a waiver. However, to claw back support will have all the implications that I mentioned earlier, but the legal aspects would need to be studied further before that step is taken.
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> The other broad question that was raised is what would be the implications of all of this for the creditor community. Already, the staff representative from the World Bank indicated that the Bank staff supports what we are proposing, but the Bank does not have misreporting procedures that are similar to ours. Therefore, there is to our knowledge no other creditor that has similar procedures that raise these kinds of issues.

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

> I would like to respond to three questions raised by Directors. First, a question was raised by Mr. Boitreaud as to what would happen if, after Ghana reached its decision point, the Fund were to introduce amendments to the HIPC Trust instrument that allowed the Fund to make downward adjustments to the amount of a debt relief commitment after the decision point; specifically, whether those amendments would apply to Ghana or to other countries that had already passed their decision points. The answer is that they

would not. They would only apply prospectively to those countries that have yet to reach their decision points.

Several Directors also raised a question regarding the interpretation of the proposed decision; specifically, whether it could be read in a way that would allow the Fund to make adjustments to the amount of a commitment after the completion point; and second, whether language could be introduced in a summing up that would qualify or provide some basis for interpreting the Board's decision in this manner. With respect to the second question first, the Fund should not try to qualify the meaning or the language of a decision through a summing up. The intent of the Board must be clearly expressed in the language of the decision itself. With respect to the specific proposed decision that is now before the Board, the intention of the staff was not to provide for the possibility of adjustments after the completion point. The reason why the proposed language does not mention what happens after the completion point is that such language would need to be included in a provision that would explain what would happen after the completion point, and such a provision is not necessary under the staff's proposal. If the Board wanted to provide for the possibility of adjustments after the completion point, it would be necessary to do so expressly in the decision. Furthermore, there would be a number of additional issues that would have to be addressed, as the staff representative from the Policy Development and Review Department alluded to. For example, the possibility of the return of resources that have been disbursed from the HIPC Trust to the escrow account would have to be addressed. At the completion point the remaining amount of the commitment would go to the escrow account for its subsequent transfer to the GRA or to the PRGF trust. These types of issues would all have to be dealt with expressly in a decision amending the HIPC Trust instrument.

In response to Mr. Kiekens's question, if there were an investigation of a suspected case of misreporting by the authorities of a country, it would be extremely unlikely that the Fund would go ahead and allow the relevant country to reach the completion point, as the possibility of misreporting with respect to the member's performance under the PRGF or an arrangement in the GRA would call into question the reliability of the information that the Fund would use in assessing the member's track record of performance for the purposes of reaching the completion point. Therefore, the issue of a possible noncomplying disbursement would have to be addressed before the completion point could be reached.

Mr. Kiekens agreed that the Board would most likely take the approach suggested by the staff representative from the Legal Department.

The majority view of the Board as to the issue of finality and how it related to the irrevocable nature of the decision point or the completion point was an incorrect interpretation, Mr. Kiekens remarked. A payment that had been made in error could not be considered as irrevocable under a reasonable interpretation of general principles of law.

It was clear that the majority of the Board was in favor of the proposed decision, Mr. Kiekens observed. However, the Board's approval of the decision would not be by consensus or unanimous.

The Acting Chair (Ms. Krueger) noted that the Board would be returning to the broader issue of information reporting in the context of HIPC Initiative assistance in March. The possibility of developing mechanisms that could be applied in cases where misreporting was discovered after the completion point but would maintain the irrevocability of the assistance provided at the completion point should be considered when preparing the upcoming papers.

The Board did not see a need to have concluding remarks in connection with the Board discussion as the Board would be returning to the issue in the following month, the Acting Chair observed. The decision was approved, but not unanimously.

The Executive Board took the following decision:

The *Instrument to Establish a Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations* (annexed to Decision No. 11436-(97/10), adopted February 4, 1997) is amended as follows:

a. The following sentence shall be added in Section I at the end of paragraph 1(v):

"For the purposes of these calculations, amounts that are subject to an early repurchase or repayment expectation established under the Misreporting Guidelines shall not constitute external debt."

b. The following shall be added in Section I as a new Paragraph 1(x):

"Misreporting Guidelines means the Guidelines on Corrective Action for Misreporting and Noncomplying Purchases in the General Resources Account (Decision No. 12249-(00/77), adopted July 27, 2000), and the Provisions on Corrective Action for Misreporting and Noncomplying Disbursements in Arrangements under the Poverty Reduction and Growth Facility (Appendix I of the Instrument to Establish the Poverty Reduction and Growth Facility Trust annexed to Decision No. 8759-(87/176) ESAF, adopted December 18, 1987)."

c. The following sentence shall be added after the first sentence of Section III, paragraph 3(e):

"To the extent that the Trustee, in determining the amount committed to the member under paragraph 3(b) above, included in the member's external debt amounts that, after the decision point, were found to be subject to an early repurchase or repayment expectation under the Misreporting Guidelines, the Trustee shall recalculate and adjust the amount of its commitment, excluding from the member's external debt the amount that was subject to the repurchase or repayment expectation." (EBS/02/18, 2/1/02)

Decision No. 12680-(02/17) PRGF, adopted
February 20, 2002

3. TRACKING OF POVERTY-REDUCING PUBLIC SPENDING IN HEAVILY INDEBTED POOR COUNTRIES

Document: Actions to Strengthen the Tracking of Poverty-Reducing Public Spending in Heavily Indebted Poor Countries (SM/02/30, 1/30/02; and Sup. 1, 1/30/02)

Staff: Ter-Minassian, FAD; Gupta, FAD

Length: 1 hour, 50 minutes

Mr. Cippà submitted the following statement:

Last spring, the staff offered us a very candid first assessment of the possibilities and limits of tracking poverty-reducing expenditures in countries benefiting from HIPC Initiative assistance. While it was always clear that deficiencies in this area exist, the results were sobering. It revealed that only very few eligible countries have the capacity to effectively track public expenditure and to undertake a timely auditing of public accounts. Much work is thus required, both of the countries concerned, and of the Fund and the Bank, to assure that the resources released through the HIPC Initiative are effectively used for poverty alleviating measures. This, of course, is a central element of the initiative.

I thank the staff for providing a follow-up on the first steps that were made out as necessary during our last discussion. The findings largely confirm those of the preliminary assessment: while most of the countries reviewed have some sort of mechanism in place to allow a rough measurement of poverty related expenditure, the majority is still far away from the capacity to effectively track and report on public spending in the areas marked out in their PRSPs or I-PRSPs. A large majority of countries does not meet such basic requirements as the compliance with the Government Finance Statistics manual or functionally based expenditure reporting. Even with the generous interpretation by the staff as to what implies the need of 'little or no upgrading', most countries surveyed fall into the category of requiring 'substantial' improvement.

As I mentioned at the time of the last discussion, I believe the staff's strategy to address the most immediate problems to be sound. While the development and implementation of comprehensive systems of expenditure management and impact monitoring should clearly be the long-term goal of authorities in the HIPCs, it will certainly be necessary to take intermediary steps. Over the short term, there is probably no credible alternative to creating 'virtual poverty funds' of the Ugandan type, simply by tagging budget lines. Some progress seems to have already been made here, as indicated by the number of countries that have implemented such schemes or are in the process of doing so.

I would in any case strongly advise the countries concerned to move ahead fast with their action plans, to seek to integrate them into their respective PRSP processes, and to request the technical assistance of donors and of the Fund and Bank where needed. As stated by staff, the responsibility for ensuring sound management of poverty-reducing public spending lies first and foremost with the HIPCs themselves. I believe that the measures to be taken to this end are an important part of what these countries should contribute to make a success of the initiative.

I also believe that the staff marks out the areas that critically require improvement over the longer term, i.e., the legal and institutional framework of the budgeting and expenditure processes, information systems, and administrative capacity. Sadly, by taking up the question of expenditure management rather late in the day of the HIPC Initiative process, we missed covering much of what needs to be done over the short and medium term through completion point conditionality. Indeed, it is regrettable that for one third of the countries that have reached their decision points so far, no measures bearing on public expenditure management were included in the completion point triggers at all. I strongly recommend that this does not re-occur in the cases to come, especially as these will include many countries with weaker track records.

Strategies to improve the measurement and control of poverty reducing expenditure should also be given a firm place in countries' PRSPs. Moreover, we must ensure that PEM-relevant measures are firmly covered by PRGF conditionality. It is encouraging to learn that the average number of such measures in PRGF programs is on the rise, and that their implementation record in the HIPCs reviewed is broadly satisfactory. Finally, we should keep the overall progress in this critical area under close review. I therefore welcome the staff's suggestion for a further follow-up. However, I strongly believe that this should be undertaken well before 2004 in order that the Board is kept informed on developments before the countries subject to the present assessment pass their completion points.

I am aware that institution building is a time-consuming process and that there might be unrealistic expectations. Nevertheless, I have a somewhat different risk assessment about the pace of reform. I had hoped for more progress since last year and would like to see concrete improvements soon. Progress would substantially enhance the credibility of the HIPC Initiative and would also lower the risk of reduced donor support. By deciding on an earlier review we would send a clear signal of the importance we attach to the issue.

As stated in the staff document, the HIPCs efforts to repair the deficits of their expenditure management systems should not only target assistance provided under the initiative, but all poverty-reducing spending. This would be consistent with viewing HIPC relief in the broader context of overall financial flows to these countries—a view that should be taken to assess the implications of sustaining current increases in social and health expenditure beyond HIPC assistance.

Finally, I agree on the publication of the paper.

Mr. Kelkar submitted the following statement:

Key Points

Well directed public expenditure in specific, identified sectors and an efficient public expenditure management system to track such expenditure is crucial to the goal of poverty reduction (paragraph 2).

The results of the detailed staff assessments ought to be viewed in the context of overall weak national capacities, and there is a need to guard against the risk of over interpretation to the detriment of HIPCs (paragraph 3).

Greater emphasis on establishing short-term mechanisms may yield quick desired results, both for the donors and the HIPCs (paragraph 4).

HIPCs stand to benefit from improved management capacities and enhanced statistical and analytical capabilities. Ownership of action plans, therefore, should not be a problem (paragraph 5).

The task of accurately segregating poverty reducing expenditure from the broad social sector heads requires much grater emphasis (paragraph 6).

Tracking only HIPC Initiative expenditure will not suffice (paragraph 7).

More attention should be paid to local capacity building in view of increasing and welcome decentralization of poverty reducing programs. The remaining gaps in assistance to HIPCs should be addressed (paragraph 8).

Ultimately, the success of all these efforts will be judged from improved outcomes. Expectations of meeting MDGs should be matched by efforts to ensure corresponding resource transfers (paragraph 9).

We thank the staff for providing a comprehensive picture of the present status of tracking of poverty reducing public spending in HIPCs and for a lucid analysis of various aspects of this issue. Since the March 2001 Board discussion, substantial progress has been accomplished in finalizing country specific assessments and preparation of action plans to improve the Public Expenditure Management Systems (PEMs). There has also been significant forward movement in identification of existing and planned donor assistance, and any gaps that might remain, and reporting on assessments of PEM reforms as part of regular reviews of Fund and Bank supported programs. As regards the future course of action, we broadly support the approach outlined in the staff paper and wish to emphasize the following points.

Well-directed public expenditure in specific, identified areas is an important tool of poverty reduction. The necessity of properly tracking such expenditure cannot, therefore, be overstated. An essential prerequisite for this, in turn, is an effective public expenditure management system. Not surprisingly, many of the HIPCs are deficient in tracking poverty reducing spending and in the absence of an efficient system of budget management, there are serious shortcomings in effectively tracking poverty reducing expenditure. In our view, this has been corroborated now by the findings of the detailed staff assessments, in particular that 15 out of the 24 countries that were assessed require substantial upgrading of their PEMs. While we agree with these findings, we would welcome staff comments regarding one aspect of the benchmarks used to determine the adequacy of PEMs. Should they be assigned the same weights in the overall characterization of a country, given the very valid staff observation that not all of them have equal importance?

It is important that the results of the detailed staff assessment are not seen in isolation but in the context of overall weak institutional and administrative capacities. We emphasize this as we share the apprehension expressed in the staff paper that a candid assessment of the existing tracking capacities may lead certain donors and civil society groups to over-interpret the conclusions. There may be a tendency to avoid the “risk” of putting in their money until there is a credible assurance that it will lead to additionality in poverty reducing expenditure and that the resources made available by them will be well spent. Such apprehensions are not unfounded, given the existence of an increasingly vocal body of public opinion in the donor countries that billions of dollars worth of aid given to the poor countries, in the past, has been wasted due to inefficiencies or corruption or both. The urgency of debt relief required by HIPCs precludes, in our view, the establishment of a comprehensive well-functioning PEM system as a precondition for debt relief. We believe that the strengthening of PEM capacities of HIPCs should proceed in tandem with the flow of debt relief and PRGF funds. The question of publishing the staff paper is related to this. In our view, the paper could be published but adequately highlighting the need to look at the situation in its totality and not to draw overly adverse inferences.

We would suggest a greater appreciation of the findings reported by the staff that despite the overall weakness of PEM systems, situation is much more satisfactory in so far as availability of broad-brush functional data on social spending is concerned. Even more encouraging is the assessment that significant strengthening of capacities can be achieved by most HIPCs within 1–3 years, given some effort and commitment. There is no reason that HIPCs should be found wanting on this account. We underscore this point and urge that greater priority be accorded, in the action plans, to achieve this possible result. This will ensure, on the one hand, that the legitimate concerns of donors are addressed in the near term; on the other, the country authorities will be able to benefit from the findings of improved tracking and undertake measures to make more optimal use of HIPC Initiative relief. Hence, we encourage intensification of efforts to put in place the short-term bridging mechanisms including the virtual poverty funds.

We have noted the concern expressed in the staff paper regarding the ownership of action plans to improve PEMs. The principal objective of HIPC Initiative is to make the debt burden of the countries covered under this Initiative sustainable so that the funds freed up from debt servicing are available for poverty reduction related spending. It is natural, therefore, for the donor community to know that more resources are being set apart for poverty reduction, to which agencies they are being allocated, to what extent are they actually being spent and how well they are being spent. We believe that the HIPC Initiative authorities are no less keen to have all this information to be able to take corrective steps wherever necessary to improve policy design and strengthen implementation. In our view, therefore, ownership of action plans to improve PEMs should not be a problem.

Another area which requires greater focus pertains to defining the poverty reducing expenditure. The authorities are specifying in their PRSP documents which of their programs are poverty reducing. Broadly, it can be seen that, inter country differences notwithstanding, the entire social sector spending is presently being categorized as poverty reducing. As the staff have also commented, this calls for refinement. For, by no stretch of imagination, all the expenditure in social sectors can be clubbed together as poverty reducing. In fact, in the absence of appropriate targeting, the results of such spending may not only fail to reach the poor but may benefit only those who are already better off. For example, increased public expenditure in the agriculture sector may benefit the rich farmers as much if not more than the poor small and marginal farmers. Similarly, in the absence of requisite enabling measures, the poor may not be able to send their children to school despite a heavily increased expenditure on construction of schools and recruitment of teachers. Considerable effort is, therefore, required in segregating such expenditure heads that can be classified as poverty reducing. Although there will be common elements, this definition will have to be country specific. This is no doubt a daunting task but important nonetheless and has to be addressed in a collaborative manner. We will appreciate staff comments on the possible approaches to this.

We endorse the view that tracking of only the HIPC Initiative assistance is inadequate. The reason mentioned by the staff is unexceptionable i.e., fungibility of resources and therefore the possibility of HIPC Initiative assistance being earmarked for poverty reducing expenditure and a corresponding decrease in own resources allocated to these sectors and programs. Furthermore, the international donor community as a whole is increasingly making the PRSP as the basis for their assistance. It stands to reason therefore that the authorities put in place institutionalized arrangements that cover the entire spectrum of resources being spent on poverty reduction. Even from their own perspective, they stand to gain in terms of enhanced statistical and analytical capabilities encompassing their entire PEMs. A compartmentalized approach meant only to satisfy a procedural requirement of a specific program, namely in this case the HIPC, will not suffice.

We are happy to note that there are now only a small number of gaps in assistance to the HIPCs in strengthening their capacities. We urge the international community that these be addressed and the Fund in particular to step up efforts at providing technical assistance and building up human resources. The staff reporting on progress in implementation of action plans will in our view help focus on this critical area. As the staff have noted, the decentralization of poverty reducing programs to local governments is becoming more significant. This is a welcome trend from the viewpoint of enhancing effectiveness of utilization. Quite expectedly, however, PEM capacities at sub national levels are even weaker. We urge increase emphasis to strengthening capacities at these levels.

Finally, the effectiveness of poverty reducing spending will be determined by the magnitude of improved outcomes. PEMs therefore need to be seen in this perspective. We agree that they will need to be supplemented by PSIAs to ascertain the actual impact of poverty reducing spending. However, when we talk of measuring the outcomes in terms of the MDGs we must also see whether the actual resource transfers to the developing countries in general and the HIPCs in particular bear any correlation to the amounts assessed as necessary for achieving these objectives.

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

The findings of this paper are hardly surprising and generally confirm existing and widely shared views on the prevailing weaknesses in the public expenditure management systems in a large number of HIPCs. As a matter of fact, these weaknesses are in no way unique to HIPCs and are quite common in many other developing countries. While the paper confirms existing perceptions, it represents an important step in identifying the specific areas that require upgrading. In that sense, it also brings into focus the importance of moving forward with steps to improve these countries' overall ability to effectively manage their public spending, and hence track their poverty reducing outlays among other public spending expenditures. This is of critical importance for policy makers as well as others, particularly donors, to judge the effectiveness of policies.

The main characteristics of the poverty reduction strategies embodied in the Poverty Reduction Strategy Papers (PRSPs) are their comprehensiveness and inclusiveness. They encompass a wide range of public policies designed and implemented with the participation and involvement of the development community. Spending on poverty reducing activities is only one element in this holistic strategy, which also includes, macroeconomic, pricing, and social policies, as well as structural reforms. It is therefore important that this element of the strategy is not looked at in isolation of the other components, that are also aimed at reducing poverty. Such a narrow approach could risk oversimplifying the inherently complex and multifaceted nature of the poverty reduction strategy and raise expectations with regard to the potential effect of poverty reducing spending programs. At the same time, one has to recognize that efforts directed at improving the tracking of poverty-reducing spending play an important role in responding to the needs of the development community, and assuring participating partners that scarce resources are being effectively spent on worthy activities.

The comprehensiveness of the poverty reduction strategies in PRSPs certainly complicates the task of defining specific poverty-reducing spending activities. In a way, drawing a sharp line between those activities that are poverty reducing and those that are not, runs counter to the logic and spirit of the PRSP. In fact, by design, all policy elements in the PRSP are aimed at poverty reduction, and therefore, any public sector activity that requires the use of public resources can be labeled as poverty reducing. Having said that, we realize that a line has to be drawn somewhere, and we agree with the staff that while there are common poverty-reducing spending activities to all HIPCs, the determination of what qualifies to be poverty reducing will have to be undertaken on a country by country basis. This will be an evolving process as countries gain more experience and knowledge in identifying effective poverty reducing programs.

The need to take action to strengthen the tracking of poverty-reducing expenditures in HIPCs stems from the widespread weaknesses in public expenditure management (PEM) systems in these countries. It is therefore desirable that efforts to achieve better tracking of poverty-reducing or, for that matter, any other spending, are undertaken in the context of existing or prospective programs to improve PEM systems in general. Given the enormous capacity building needs of HIPCs and the limited existing implementation capacity, it is best that efforts, are directed at the broader area of PEM systems reform rather than be narrowly focused on one element of those systems. While temporary measures such as the bridging mechanisms mentioned in the paper, may be useful from a short-term perspective, they could well lead to delays in taking more fundamental reforms in PEM, as they risk diluting the urgency of these reforms. As far as reporting on progress in implementing action plans, we of course expect to be updated on developments in this area, particularly in cases where PRGF programs include measures to improve PEM systems. In this regard, any inclusion of the action plans in program conditionality should be confined to matters directly related to PEM reforms and with direct macro relevance, as is the present practice.

Another complication in the process of improving PEM systems and tracking poverty-reducing spending is the delegation to local authorities of the responsibility of implementing poverty-reducing programs. Not only are PEM systems at local levels weak, but improvements therein also require significantly more efforts than at the central government level. While there may well be good reasons to favor, in principle, local responsibility in implementation, the serious weaknesses in PEM capacity at local levels in fact shed doubt on the assertion that implementation of poverty-reducing programs at the local level is more effective. Even if one assumes that decentralization leads over time to more effective implementation at the local level, at this time there is a clear tension between this objective and that of tracking spending in the countries concerned.

With regard to the role of the Fund in the effort to improve PEM systems, we certainly support the continuation of the existing work particularly in the area of technical assistance. Given the multitude of parties involved in PEM type of assistance to HIPCs, we see a need to pay particular attention to issues of coordination between the different providers of technical assistance. This is needed not only to avoid duplication of work but also to prevent giving conflicting advice. In this regard, coordination between providers, particularly the Fund and the World Bank, should be accompanied by a clear delineation of responsibilities based on areas of mandate and expertise. Being key partners in the poverty reduction strategies of HIPCs, it should be emphasized, and hopefully well understood by all, that the role of the Fund and the World Bank in the area of public expenditure management is only a narrow component of their large contributions to the ongoing poverty reduction efforts.

Mr. Varela and Mr. Garner submitted the following statement:

The process of implementing a PEM System calls for many elements that are not easy to have in place right away, i.e. capacity building, legal and regulatory framework, aspects that will require further financial and technical assistance.

Using the PRSP process will allow for better coordination among donors of the resources that they are willing to deliver to the beneficiary country.

The implementation of a well-integrated financial management system will reassure donor countries that, from a fiduciary perspective, their assistance is used accordingly, while from a governance perspective, the same goal is also desirable for the citizens of the beneficiary country.

We deem the publication of the paper appropriate, with the purpose that it become a guide for the authorities and donors to the path ahead. This guide can be useful not only to the sample countries, but also to other countries that are beneficiaries of the HIPC Initiative and middle-income countries with weak PEM.

Aspects such as ownership, lack of legislation, and human capital are elements that could jeopardize the development of the PEM systems, yet, as we have seen in the background paper, these aspects vary from country to country, and in some way they represent stages of the implementation process that are likely to be completed in time by the beneficiary countries as they continue with the implementation process.

At the outset, let us thank the Staff of the Fund and the World Bank for a well-written set of papers that give us an update on the recent actions taken to strengthen the tracking of poverty-reducing public spending in Heavily Indebted Poor Countries (HIPCs). We believe that the findings of this research over the Public Expenditure Management Systems (PEM) of a well though sample of HIPCs indicate that most of the countries that are beneficiaries of the initiative need to go through a lengthy process in order to have an efficient tracking system of their poverty–reducing public spending, as it can be inferred from the background paper, a document that we have found very useful. Consequently, a bridging mechanism or virtual poverty funds are palliatives in the interim as these countries, according to their capacities and with the help of donor institutions, need to continue developing well-functioning PEM systems in the medium term.

We consider that these action plans and strategies, envisaged to achieve a well-functioning PEM, are adequate, yet it is very important to keep in mind that the process of implementing such measures requires many elements that are not easy to have in place right away, such as: capacity building (Human resources training, especially in software systems design), legal and regulatory frameworks, aspects that will require further financial and technical assistance. Therefore, we coincide with the staff's views that the countries should use their PRSP process to solicit donor assistance for the full implementation of their actions plans, as this will allow for a better coordination among donors of the resources that they are willing to deliver to the beneficiary country.

Furthermore, we agree that in order to obtain a more manageable and better-prepared budget, it is essential to develop medium-term expenditure frameworks and budget classification systems. The implementation of a well-integrated financial management system will not only give us a better budget but will also offer donor countries an assurance that, from a fiduciary perspective, their assistance is used accordingly, while, from a governance perspective, same goal is also sought by the citizens of the beneficiary country.

It is important that the staff continue with their assessment of the advances in the implementation as part of the normal review of the Bank and Fund supported programs, with the purpose of indicating to the authorities the aspects of their PEM systems that need improvement and to the donor partners the elements that need to be financed.

For that reason, we deem appropriate the publication of the paper, with the purpose to make it a guide or map for the authorities and donors to the path ahead. This guide can be useful not only for the sample countries but also to other countries that are beneficiaries of the HIPC Initiative and middle-income countries with weak PEM.

With regard to the risk factors, we are heartened by the fact that lack of financing is not one of them, been this an indication that donors concur with the staff's perspective that the ultimate goal is to improve governance of public expending with the purpose of reducing poverty, therefore the PEM System is a cause worthy of support. On the other hand, aspects such as ownership, lack of legislation and human capital are elements that could jeopardize the development of the PEM systems, yet, as we have seen in the background paper, these aspects vary from country to country, and in some way they represent stages of the implementation process that are likely to be completed in time by the beneficiary countries as they continue with the implementation process.

Finally, we agree that the next comprehensive report on the implementation of the action plans by the HIPC Initiative to strengthen the tracking of poverty reducing publics pending should be provided by the end of 2004.

Mr. Al-Turki submitted the following statement:

Key points

While the Poverty Expenditure Monitoring (PEM) effort is crucial for success of the HIPC Initiative, it should be designed to minimize additional burdens on the limited administrative capacity of the HIPCs.

The PEM effort should be pressed in the context of broader budgetary reforms.

Timely provision of the needed technical assistance is critical for success of the PEM effort.

It is important to approach the PEM effort in a pragmatic manner.

Staff has provided an informative and helpful update and action plan on the tracking of public spending to help reduce poverty in the HIPCs. The importance of the PEM effort cannot be overstated since it is critical to ensure focus on poverty reduction in the allocation of a member's net resource gains under the HIPC Initiative. At the same time, the report, including especially the country-specific background study, further confirms the inherent conceptual and practical difficulties of this exercise. Indeed, a fully satisfactory system for tracking of poverty reducing fiscal outlays would be a challenge for countries that have a far more advanced technical and administrative capacity than the HIPCs.

The immensity of the challenge is evident. Indeed, while staff identifies only two out of the twenty-five HIPCs as likely to have the capacity to track poverty-reducing public spending, even these countries are noted as requiring "a small amount of upgrading of their public expenditure management systems". This underscores the importance of setting goals that are feasible within the available resources. I will add a few remarks in that context.

It is important to stress that the additional burden on HIPCs for tracking of poverty reducing outlays should be minimized in view of their limited implementation capacity. I therefore welcome staff's practice of combining the PEM work with the regular missions of the Fund and the Bank. Keeping the questionnaires simple and focused on the basic aspects of budget formulation, execution and reporting in a country is also crucial. Given the variety of country experiences reported in the background paper, I agree with staff on the need for caution in evaluating the assessments. In particular, the findings are useful mainly to monitor and evaluate poverty related spending for a given country across time rather than to draw any conclusions on the relative performances across countries.

It is evident from the staff's background paper that the shortfalls in formulating, executing and reporting poverty related outlays in the HIPCs is an aspect of the broader problems of a country's budgetary procedures and practices. This further confirms that an excessive concentration on perfecting just the tracking of public spending on poverty reduction can be wasteful. Indeed, a poverty module, however sophisticated, cannot be effective in isolation from the effectiveness of the underlying budgetary process. It is thus critical to improve the poverty related spending module in step with the overall budgetary reform process. This applies equally to the challenge of improving the data on poverty-related spending in tandem with improvements in budgetary statistics in general.

Against that background, I share staff's stress on integrating the PEM work with the broader ongoing programs for reforming policies and practices in the HIPCs. While the precise shape of a bridging mechanism will depend on country circumstances, the focus should remain pragmatic. Specifically, the aim should be to gather the usable information to help form a reasonably reliable impression of whether a country's poverty-related spending has evolved in line with the expectations under the HIPC Initiative. To that end, a continued Fund commitment to provide the appropriate technical assistance is critical. In that regard, I support the active efforts reported in Box 2. However, close monitoring of the effort is essential to both optimize use of the available resources and to ensure a timely bridging of any emerging gaps in the assistance.

The staff's findings highlight the essentially open-ended nature of the poverty-specific as well as broader systemic reforms that are important for a satisfactory system of monitoring poverty-reducing expenditures. Given the resource constraints, it is essential to take a pragmatic view of what can be achieved. In particular, while I broadly agree with the proposed action plan, it is crucial to avoid any unduly expansive view regarding the precision or comprehensive coverage in the tracking of poverty reducing expenditures. The conceptual and practical problems of the PEM effort and the need, therefore, for pragmatism should be highlighted in revisions of the paper before publication.

In conclusion, I welcome the staff's candid assessment of the risks in the action plan. In particular, I share the staff's views on the long-term and fitful nature of the progress in institutional reform. Indeed, given the systemic limitations, any excessive reliance on fiscal monitoring of specific projects can have unintended adverse consequences for all parties and especially the HIPCs.

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

Last year’s report on tracking, which indicated it would take many years before all but a handful of HIPCs had systems in place to credibly track poverty spending, served as an important wake up call. It made clear the need for much greater attention by governments under the HIPC Initiative and their partners, including the IMF and the World Bank, to the fundamental question of how resources are actually utilized in these countries. The question required both near-term and longer-term answers. Today's report rightly highlights the importance of shorter-term bridging mechanisms that countries are introducing to facilitate immediate tracking of HIPC Initiative and other poverty-reducing spending while medium- to longer-term mechanisms are being strengthened. At the same time, the development of action plans by most HIPC governments with Fund/Bank assistance to strengthen existing tracking capacity over the medium term represents an important step in addressing fundamental weaknesses. We also note the clearer commitment by Fund/Bank management to prioritize in their operations the strengthening of overall public expenditure management (PEM) in borrowing countries. As such, we can endorse the reports key recommendations, with the following clarifications and observations:

The Role of the Fund and the Bank

We agree with the staff’s argument that the success of this initiative will depend on countries’ willingness and capacity to integrate the action plans into their own reform agendas, including their PRSPs. Such integration will ensure that tracking is a central component of each country’s own growth and poverty reduction strategy.

That said, the Fund and the Bank also need to be accountable in their support for these efforts. The Fund should reflect countries' progress in evaluating overall fiscal performance. The Fund and the Bank will also need to continue their efforts to work closely with HIPC governments to report on the use and additionality of HIPC Initiative-specific resources in PRGF and PRSP documents. While we agree with the staff that a HIPC-only framework does not make sense, the credibility of the HIPC framework requires that countries are able to account for the additionality of HIPC expenditures, within their overall poverty reduction efforts. We see the potential failure to meet this need as a fundamental risk for the HIPC Initiative, and it should be included among the other risks highlighted in the paper.

The report highlights the important role that ROSCs can play in supporting stronger PEM systems. It is notable in this regard that so few modules have been completed in total and that the pace of ROSC preparation appears to have stalled. We would appreciate the staff’s comments on this issue.

We are concerned that some important elements of well functioning PEM systems, particularly procurement systems, were not directly included in the assessments. Going forward, we request that procurement systems be specifically included. The explicit incorporation of this key ingredient of public sector management is essential to a credible assessment.

Form and Scale of Donor Support

In terms of other risks, we believe the paper overplays the risk of a reduction of donor support for system-wide approaches (typically budget support or programmatic adjustment lending) for two reasons.

First, we have seen a strong willingness of HIPC country partners to support these efforts, even after last year's very critical report. (We agree that broad-based donor support is critical to the success of country efforts.)

Second, in terms of the form of support, the framing of paragraph 61 seems to suggest that general budget support is a preferred form of financing. We have not seen evidence that budget support is more effective than other forms of assistance. While in general we believe that the paper does a good job in recognizing that the choice in the form of support and its scale should continue to depend upon the situation in individual countries, we believe that paragraph 61 could use a closer look.

While we agree with the long-term objective outlined in paragraph 39 that donor support should ultimately be channeled through government PEM systems, this paper indicates that such a framework will be unlikely for some time in most countries. We cannot endorse any strategy that would suggest that donor resources should be channeled exclusively through such systems before they can provide satisfactory tracking and measure results. This does not argue against system-wide approaches, nor against strong support for capacity building in the interim.

Donor Coordination

With over 25 bilaterals and multilaterals providing assistance to HIPCs on PEM, a clear framework for determining how donor coordination will be handled is critical, including in terms of the division of labor between the Fund and the Bank. Clear treatment of the question of PEM needs and follow-up plans in the PRSP should serve to support strong coordination. We believe that the Fund and in particular the Bank can play a pro-active role in supporting these efforts, including through the CG process and assessments. Action plans should be routinely featured in Fund/Bank country programming documents. More specifically, the Fund should reflect country performance on PEMs in its surveillance and incorporate it as a key component of fiscal policy reforms. The Bank needs to make PEM diagnosis and strengthening a fundamental component of its operations.

Specific Country Assessments

It is quite troubling that Guinea-Bissau, which reached decision point in late 2000 has not defined an action plan to address PEM weaknesses. An assessment and action plan should feed into their PRGF and full PRSP review. At the same time, it is critical that a PEM assessment and action plan be an integral component of the work program as Côte d'lvoire reengages with the IFIs. We would appreciate further information regarding both cases, including the sources of delay in the case of Guinea-Bissau.

We note with some concern the fact that Ghana—whose Decision Point is pending—meets only one of the framework's benchmarks. This issue will obviously require strong attention during the interim period.

Other Issues

Findings: We do not have sufficient information to address the first question in paragraph 63, regarding the validity of the country specific findings. We do appreciate the information that the staff has provided regarding the assessment framework and, in paragraph 15, its limitations. We also appreciate the background paper on specific country findings.

Review: We agree that the issue of PEM should be included in regular country reporting. We also agree that a more comprehensive review of progress should be completed by spring 2004.

Disclosure: We believe that the paper for today's discussion should be disclosed, with appropriate revisions to reflect Bank and Fund Board discussions.

Mr. Usman submitted the following statement:

Introduction

We thank the staff for this timely and useful update on progress being made to improve public expenditure management systems (PEMs) in HIPCs. While it is difficult to compare the status of expenditure tracking systems between early 2001 and now, noticeable improvements have been made. As we mentioned in the discussion of March 2001, provision of technical assistanceis critical to build capacity for HIPCs to track poverty-reducing expenditures. It is welcome that the current paper has made an assessment of the gaps in tracking systems and also provides some detail on the criteria for assessing and for monitoring progress, thus laying the basis for proceeding more systematically. The key building blocks to ensuring faster progress are for the HIPCs themselves to demonstrate strong commitment towards self-improvement in the areas in question and for the IFIs and the donor community to ensure the timely provision of the necessary technical assistance. We broadly concur with the outline of the next steps and have the following comments.

Gaps in PEMs

The key parameters for assessing PEMs are formulation, execution and reporting. As reflected in paragraph 17 of the staff report, most countries seem to fare well on formulation. Significant gaps remain on execution and reporting. However, in paragraph 30, which discusses the areas where substantive changes are envisaged for PEMs systems in the medium to long-term, there is greater emphasis on the need for improvements in formulation and reporting and we feel the importance of execution has been overlooked or taken as a residual. We wish to highlight that HIPCs have always lacked capacity for implementation and execution and this problem has been most acute in the execution of projects, including public sector investment. Execution is the key process through which PRSP expectations are realized and improvements are required to enhance the absorptive capacity. Without making a judgment on merits of a centralized as opposed to a decentralized system, it would appear many countries are pursuing decentralization as the important vehicle for executing poverty reduction programs, yet PEMs are weaker at the local government level. It is important that the World Bank and other players who provide technical assistancein this area intensify their effort.

PEMs and Fund-Supported Programs

The Fund is rightly putting a lot of emphasis on strengthening PEMs within the context of PRGF programs. As pointed out in paragraph 43, an average of about six formal conditions or expressions of intent on PEMs are included in PRGF programs, in addition to conditionalities in other areas. We should remain conscious, however, that such conditionality, while important, should remain consistent with the overall objective of streamlining conditionality and provision of technical assistanceis important to complement the effort of countries to meet these conditions. We are indeed aware that there are competing demands for technical assistancewithin the Fund but we urge that this area should not suffer in the process. In this regard, the staff have highlighted the important role that regional technical assistancecenters can play in this process. However, while the Fiscal Affairs Department is the focal point of the Fund's work on PEMs, we wonder whether such expert small number of fiscal experts being assigned to these regional centers will not be overburdened. Staff comment will be appreciated in this regard. It is important also to emphasize that the role of short and long-term experts that the Fund provides should be to build capacity, rather than for them to become indispensable such that when they are to leave and in the process, extension of their stay is repeatedly sought thereby depriving other countries of their technical assistanceexpertise.

PEMs and Bank Support

We commend the work of the Bank on improving PEMs in HIPCs. However, while we appreciate that conditions on PEMs are a key feature in Bank supported programs, we are concerned that the Bank provides loans to HIPCs to finance technical assistance for improvements in PEMs without regard to the capacity of HIPCs to pay which seems to run counter to calls for more grant assistance from the Bank. This is a pertinent concern as we have noticed in certain countries in our constituency that Bank loans for PEMs could actually be crowding out grant-funded technical assistancefrom donors. Also Bank programs have contained conditions relating to public expenditure management reform from way back in 1995 and there is need to improve the effectiveness of technical assistance. We wish to make the point also that, in recruiting consultants, it is important that the Bank should draw as much as possible from local expertise in order to help build more capacity and enhance country ownership. Comment from the World Bank representative on these issues would be appreciated.

Bank/Fund Collaboration

Once again, we commend the efforts being made by management and staff of the two institutions to improve collaboration. However, we believe a number of areas need further improvements. First, the fact that the two institutions maintain different policies on the same issue, where the Bank charges HIPCs for technical assistancewhile the Fund doesn't, creates room for frictions between the two and there is need for harmonization of these policies. Second, while the Fund has taken a leading role in many HIPCs, we notice that the Bank is doing so in the others. We hope that there are no major divergences in approach and that no marked differences will surface as regards the progress made in the two groups of countries and that an undue burden on paying for technical assistanceshould not be placed on those countries where the Bank is taking the lead. Third, while the HIPC Initiative and PRSP processes ought to be joint effort between the two institutions, we notice in some of our countries that frictions do occur among the staffs particularly in such areas as coordination of the PRSP process as to who takes the lead in macroeconomic assessments, setting cross-conditionalities, etc. In this connection more collaboration is also needed in catalyzing and co-coordinating technical assistancefrom donors. We urge staff and managements to therefore continue intensifying their efforts to improve collaboration. In fact the two Executive Boards should monitor more closely such countries where such problems of collaboration have been identified, to make the work of the staff and management easier. A comment from both staffs would be appreciated.

Donor Funded Technical Assistance

We thank Donors for their assistance in improving PEMs. In fact the staff note that given the intensive work of donors and their readiness to continue assisting in this area, there is no shortage, per se, of technical assistance. Instead what is needed is for the donors to continue delivering on their pledges, to provide this assistance in a timely fashion, to better coordinate the technical assistanceand for the HIPCs to use this technical assistancemore effectively. In our discussion of March 2001, we echoed that the capacity for tracking expenditures should be extended for the whole public sector budget, precisely because almost all categories of public spending contain some element of poverty-reducing element and also that money is fungible. It is also important that donors extend more of their assistance in the form of budgetary support help shift focus towards PEMs in general.

Obligations of HIPCs

Effective use of technical assistanceand the timely implementation of policy measures by the HIPCs are of the utmost importance and we will intensify our efforts in this regard. However, the risks mentioned by the staff are pertinent and that there is need for pragmatism on the part of the IFIs and the donors in assessing progress and in encouraging countries to stay on course.

Conclusion

We support that the next assessment of this issue be completed by 2004 and welcome the publication of the staff report.

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

Debt relief under the enhanced HIPC framework of debt that was actually being serviced has the potential to generate considerable resources that can be used towards poverty alleviation. All countries that qualified for HIPC Initiative relief have more than tripled their spending on priority social sectors, especially on education and health, relative to debt-service commitments. Furthermore, by improving the efficiency of these outlays and by shifting the overall composition of public spending in favor of pro-poor programs, social spending in HIPCs could rise beyond the released resources. A public expenditure management (PEM) system that effectively tracks these outlays provides credible assurances that HIPC assistance and other donor funding are being used as intended, and may help protect poverty-eradication programs from undesirable cuts in the event of fiscal pressures.

Last year, preliminary desk assessments of PEM capacity indicated a general weakness in country systems to identify and report all budgeted and actual spending for poverty reduction. In their final assessments based on discussions with country authorities, staff confirms this rather bleak but realistic situation. However, we are pleased to note that, despite the overall limited capacity, some country PEM systems are already providing the requisite data on poverty-reducing and social spending in a format consistent with the requirements of their PRSPs. Moreover, many HIPCs have witnessed improvement from a year earlier in budget formulation and, to a lesser extent, in budget execution.

The action plans and strategies outlined by staff to improve the capability of PEM systems to more efficiently track poverty-reducing spending appear broadly appropriate. In particular, we support the use of bridging mechanisms, such as "virtual" poverty funds, to make immediate tracking possible in the interim. Whatever the short-term measures implemented, however, they must be consistent with a medium-term framework aimed at strengthening budgetary and PEM systems. Nevertheless, we are concerned that there might be a risk of focusing too much on PEM systems, to the detriment of broader institutional and governance reforms that seek to address the more fundamental problems of financial management in the public sector of HIPCs.

As we have repeatedly stated, the need for technical assistance to meet the challenge of capacity building in HIPCs is enormous and cannot be overemphasized. In the specific case of public expenditure management reform, the Fund and the World Bank should continue working together to provide the necessary assistance to HIPCs. Such Bank-Fund collaboration, however, must be guided by the need for each institution to remain focused on its core mandate and main areas of expertise and competence. Fund technical assistance should remain geared towards strengthening macrofiscal management.

We welcome the bilateral assistance being provided to HIPCs in strengthening their PEM systems, especially in those areas identified as needing upgrading, and look forward to continued support.

On the issue of risks, we believe that it is very important to be realistic and pragmatic since considerable resources and time are needed to reap the benefits of these major reform efforts. Even with full commitment on the part of countries, the staff's expectation that most HIPCs can significantly enhance their PEM systems over the next one to three years seems optimistic to us. The most important element of this endeavor is that the countries concerned should own the action plans and strategies to improve the capacity of public expenditure management, by incorporating them into their PRSPs and other country documents.

Finally, we agree that staff should report on the progress in strengthening the capacity of PEMs in HIPCs as part of the normal review of Fund- and Bank-supported programs, and that the next comprehensive report on implementing these action plans should be provided no later than the end of 2004. We would suggest that significant emphasis be given in this report to the poverty and social impact analysis of expenditure programs as a critical next step in tracking poverty-reducing expenditures in the HIPCs.

Mr. Daïri submitted the following statement:

We thank staff for the well-written paper, spelling out the key parameters for effective tracking of poverty-reducing spending in HIPCs. We also commend staff, in particular, for incorporating the public expenditure management (PEM) assessments into existing work programs, thereby reducing the burden on the countries involved as well as on Bank and Fund staff. We are also pleased with the cooperation between staff and country authorities in conducting the assessments, which has clearly enhanced ownership.

Improving PEMs in HIPCs is important for ensuring that poverty-reducing spending reaches the intended targets. While we are encouraged by efforts by the countries and donors to bring available PEMs to acceptable standards, staff assessments have revealed severe shortcomings in PEMS of HIPCs. A large majority of the surveyed countries require “substantial upgrading” of their PEMs to improve budget preparation, implementation, and reporting. As stated by staff, this task is time-consuming. Moreover, given that individual HIPCs are at different stages in developing their PEMs, the time frame for attaining acceptable standards will vary from country to country. The ultimate responsibility for ensuring effective tracking of poverty-related spending should, in any case, remain with the individual countries. The necessary encouragement and assistance should be provided by the international community to enable countries to carry out PEMs reforms at their own pace. Defining a rigid PEM blue print for all HIPCs would not be the right approach; it would be best to establish basic, broad parameters for countries to follow. We, therefore, support a gradual approach to establishing acceptable PEMs, while helping countries to develop their administrative capacities.

Tracking poverty spending over the medium- to long-term would require substantial institutional reforms and capacity building. In particular, fully-functioning MTEFs and IFMISs would significantly improve budget classification, execution, and recording. While the long-term reforms are being implemented, there will be a need for short-term arrangements to ensure immediate tracking of poverty spending. We, therefore, welcome the use of “bridging” mechanisms involving “virtual” poverty funds to tag and track poverty-reducing spending in budgets. It is noted that some countries have created sub-accounts at the central bank to track HIPC-related spending. However, since HIPC assistance should be a supplement, rather than a substitute, to countries' own pro-poor spending, a comprehensive tracking of all poverty-reducing spending to ensure additionality of HIPC funds should be the ultimate goal. Furthermore, as suggested by staff, it will be helpful for HIPCs to develop their capacity for carrying out poverty and social impact analyses (PSIAs) in the context of their PRSPs to enable assessment of the effectiveness of poverty reducing strategies.

While noting and welcoming the scale of donor assistance to improve PEMs in HIPCs, complacency should be avoided since the full quantification of the required support is still to be completed. It is hoped that existing gaps in assistance, identified by staff, will be closed. We therefore join other Directors in calling for timely donor assistance to improve PEMs in HIPCs. Particularly important is assistance for capacity building through training and initiatives to attract and retain quality staff in order to ensure availability of local expertise to improve and man PEMs.

As staff cautions, care should be exercised in using these assessments beyond their purpose and, particularly, in making cross-country comparisons. Countries will need time to implement prescribed action plans. We, therefore, agree with staff that another comprehensive review may not be necessary before 2004. However, there will be a need for follow-up reviews, including in the context of Bank-Fund supported programs, to monitor progress. We agree that action plans for PEM improvements should be incorporated into country PRSPs to ensure effective implementation as well as ownership. We, however, agree with Mr. Al-Turki that the action plans should be designed in such a manner as to avoid over-burdening the limited administrative capacities of HIPCs.

We note the potential risks to the initiatives to improve PEMs both within HIPCs and in the donor community. On the part of countries, broad support for needed PEM reforms will require reinforced articulation and broad discussion of planned strategies to enhance consensus building and ownership. For the donor community, it is important to avoid unrealistic expectations and to maintain support for strengthening PEMs within the broader agenda of promoting ownership and good governance. We agree to the publication of this paper.

Mr. Barro Chambrier submitted the following statement:

I welcome the opportunity to discuss progress in the assessment of HIPCs' public expenditure systems. Strengthening the tracking of poverty-reducing public spending and monitoring the results of pro-poor programs and actions are essential elements of an efficient use of HIPC relief, but more importantly, they are crucial for countries' poverty reduction efforts. It is therefore essential to underscore the need for countries to strengthen the tracking of poverty-reducing spending in a broader context, beyond the use of debt relief under the HIPC Initiative. Such an approach will safeguard the attainment of the intended objective for the use of debt relief under the Initiative, but will also contribute to institution building and enhancement of policy implementation in the fiscal area.

I support the approach used by the staff in finalizing the assessment. Collaboration with the World Bank is important, and the close involvement of the authorities is essential for the strengthening of ownership which, as rightly pointed out in the report, is needed for the successful implementation of the action plans. Consequently, I welcome the fact that, Fund and Bank instruments used to develop country assistance programs on PEM systems, complement each other.

The findings of the assessment, as illustrated in Fig.1 are quite telling on the need for technical assistance to HIPCs to build adequate PEM systems. I am comforted by the Staff's statement that "there is no apparent shortage of assistance in the PEM area", and that the assistance being offered almost matches the needed reforms. I hope that assistance providers will maintain their commitments to ensure that new gaps are not created, and that countries will carry out their action plans in a timely and efficient manner. Given the magnitude of identified needs, and administrative capacity constraints, it will be important not to overwhelm countries in the implementation of PEM-related measures. Therefore, assistance in strengthening PEM systems, and in tracking poverty-reducing spending, including the impact evaluation, should be built on an efficient sequencing of actions to be put in place, and a well-coordinated donors' assistance.

Since the evaluation of the budget management looks at budgetary procedures in the areas of formulation, execution and reporting, the deficiencies identified by the assessment also underscore the importance of institutions and capacity building. In this context, I welcome the fact that short-term bridging mechanisms, which were established in some countries for the immediate tracking of poverty-reducing spending, were consistent with needed medium-term improvements in PEM systems. Nonetheless, it will be important to determine when and how to phase out these short-term mechanisms, while building sustainable PEM systems.

I agree with the provision of progress report in implementing action plans as part of the normal review of Fund and Bank-supported programs. However, I would appreciate staff's comments on the selection of 2004 for the next comprehensive report of action plans by HIPCs? Could this period be shortened to 2003?

Finally, I support the publication of the paper.

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

We welcome the finalized overall assessments and key action plans of public expenditure management (PEM) systems agreed with HIPC authorities. The country-specific information in the background paper and the results presented help to address the risks embedded in this initiative and facilitate the immediate tracking of poverty reducing public spending in HIPCs. The conclusions in the accompanying document points to a generally weak state of PEM systems in heavily indebted poor countries. This only reaffirms, in our view, the need not only for political will but also for greater financial and technical assistance resources, to narrow the institutional and administrative gap that breeds insufficient accountability and efficiency in budgetary management.

We reiterate our support for efforts to improve the institutional capacity for budget formulation, execution and reporting, as well as for implementation of good policies, including judicious tracking of HIPC assistance to facilitate progress in poverty alleviation. It is difficult to conceive meaningful poverty reduction strategies in HIPCs without adequate international relief, commensurate with their capacity constraints for managing budgetary resources.

Notwithstanding the critical role of country ownership over the policy content, there is ample scope for improved coordination and collaboration by the international community in the development of more comprehensive budgetary systems, as part of an ongoing process of structural reform and capacity building. We welcome the close collaboration between World Bank and IMF staff and country authorities in the review of the tracking process. However, for this effort to bear fruit, i.e. the timely production of the requisite data to monitor progress in poverty reduction, tracking of budgeted and actual outlays should involve all poverty-reduction related spending, including "virtual funds" and not just that covered by HIPC resources. Additionally, it is important to keep in mind the administrative capacity constraints arising from the devolution of public expenditure to subnational jurisdictions, which is the flip side of the substantial progress on fiscal decentralization achieved by many HIPC countries. The process of extending integrated financial management information systems to municipal governments should be seen as a long-term objective that, in turn, requires a realistic costing. This underscores the need for realism in the formulation and sequencing of action plans to be included in PRSPs, to achieve real efficiency gains from public spending and reinforce ownership.

More strategic implementation and effective allocation of assistance, in particular donor-financed expenditures, inevitably involves a learning curve not just for the recipient countries but also for the international community. From a fiduciary perspective donors rightly need assurances that resources released under the HIPC Initiative will be allocated to poverty reduction. On the other hand, recipient governments need to allocate and implement public expenditures consistently with their respective poverty-reduction strategies in generally volatile external and domestic conditions, which could have a major impact on their macroeconomic performance. Safeguarding HIPC resources and the reform process, therefore, requires that donors, recipient countries and international financial institutions complement each other in the timely provision of financial and technical assistance. It is in this context, that we welcome the HIPC action plans aimed at introducing short- and medium-term improvements to their PEM systems in light of the agreed preliminary assessments. It is in this sense that the identification of additional assistance in support of country action plans assumes particular relevance.

We find merit in the fact that action plans are intended to complement and not substitute for the existing set of programs and instruments. Conceptually, we concur with the short-term actions to strengthen commitment controls and routine reconciliation of government accounts. Staff note that “bridging mechanisms” have been advanced by “tagging” certain budget line items and by providing a subsequent virtual poverty fund. In this respect, we attach importance to concomitantly advancing output indicators to gauge dynamically the social and economic impact of such spending. This suggests the desirability of a case-by-case approach for expenditure reporting.

Notwithstanding efforts to gather and report the best available information contained in paragraph 26 of the staff paper relating to short-term measures to strengthen PEMs, we consider that these actions should advance within medium- to longer-term strategies. The role of legislative and regulatory frameworks is critical to strengthen the ability to implement and enforce the economic and social objectives of budget expenditures and more generally build up confidence in the budget process.

We generally endorse the approach for strengthening PEM systems and macrofiscal management particularly in PRGF-supported programs when assistance is being provided in the form of general budget support. While we concur with staff on the desirability of reinforcing MTEF and budget classification systems to improve budget preparation and execution, the starting position of precarious budgetary systems in heavily indebted poor countries justifies resort to multi-year projections as a second best alternative.

The close cooperation between IMF and World Bank staff is deemed essential to avoid duplication as well as gaps in assistance. Both institutions should work from a clear “a priori” identification of responsibilities. Their joint work should help focus the assistance of MDBs and bilateral donors on improving budgetary effectiveness. Given that assessments are conducted by different mission teams, it is vital to maintain smooth communications and a proper compiling effort. The availability of adequate MDB financing to build-up capacity to track spending under the enhanced initiative remains our principal concern and should be addressed flexibly so as to facilitate achievement of macroeconomic targets agreed with the Fund. We also strongly support the provision of technical assistance in order to increase budgetary effectiveness. The Fund and the World Bank should continue to encourage HIPCs to further improve their PEM systems and to link the process to an actual estimate of the potential need for IMF and World Bank technical assistance missions and resident experts.

We support the publication of the main staff paper SM/02/30 to provide a roadmap and incentives for faster reform and implementation. The Fund should, however, also be prepared to play a supporting role, including on reporting of progress in implementing action plans. This communicational procedure would ensure that each program, be it formal or staff monitored, reflects the circumstances and priorities of the HIPC country concerned.

In sum, we encourage the Fund and the Bank to continue to take a pragmatic and complementary approach to build up on existing PEM systems in HIPCs and improve institutional capacity to facilitate implementation of more robust MTEFs.

The Director of the Fiscal Affairs Department (Ms. Ter-Minassian) made the following statement:

There were a number of questions raised in the statements. Mr. Kelkar asked whether benchmarks should have been assigned the same weights in a country's assessment, given that not all of them have equal importance in each country's circumstances.

From the purpose of allowing tracking, some benchmarks are of greater relevance than others, including, notably, the existence of a functional classification in the area of reporting. Some of the benchmarks are also particularly demanding—for example, the fact that there should be comprehensive data for all levels of government. Even in some middle-income countries, it is difficult to meet such a benchmark. Nevertheless, the staff considered that giving a particular numerical weighting to different benchmarks risked being arbitrary. The whole assessment mechanism is rather intended to provide guidance for each individual country on its main needs, and on the progress that it is making in meeting these needs. Clearly, some countries will fall short more than others vis-à-vis the benchmarks. This would also have been difficult to reflect in a numerical weighting scheme without adding too much complexity and making intercountry comparisons very difficult.

In summary, we look at the assessment process as a way of systematizing the dialogue with a country on the part of institutions that are involved in supporting, through technical assistance, the improvement in the country's public expenditure management system, and as a way for a country to measure its current shortfall vis-à-vis generally acceptable standards of good public expenditure management, as well as the progress that is going to be made over time to meet the objectives.

Mr. Kelkar also asked about the definition of poverty reducing spending, mentioning that it had to be country specific. Clearly, the definition of poverty-reducing spending has to have an element of country specificity. It has to be linked to the PRSP process and document. Over time, as the PRSP documents improve, and as each country's poverty and social impact analysis is refined, one can expect that the definition of poverty-reducing spending will become more focused.

There were also some specific questions from Ms. Lundsager and Mr. Dohlman on the action plans, and on the reasons why some of the countries in the HIPC group have not yet been covered by the assessment plan—in particular, Guinea Bissau and Cote d'Ivoire. As far as Guinea Bissau is concerned, a Bank-led mission is currently in the field to carry out this assessment. It was delayed essentially for logistic reasons, given the difficulty of finding the appropriate staff to carry out the assessment, because of language limitations. For Cote d'Ivoire, while a specific assessment date is not yet fixed, we expect to be carrying it out soon in collaboration with the Bank, and possibly in connection with the ROSC that should be taking place within the next few months. The delay was due to the fact that the country is only now beginning to engage with the Fund in discussions on a program.

Ms. Lundsager and Mr. Dohlman also asked about the progress with ROSCs. ROSCs to HIPCs have accounted for about 40 percent of the ROSCs completed in fiscal 2002. Currently, we have completed about thirty-six ROSCs, of which about twelve have been to HIPCs. We expect to complete in the next few months about another twenty ROSCs, and fifteen or so in the course of fiscal year 2003. Therefore, I would not call this an insufficiently ambitious program. In fact, considerable work and resources of the Fiscal Affairs Department have gone into this effort last year and are expected to go to this activity next year. Of the ROSCs that are proposed for the next fifteen months or so, approximately eight are HIPCs, and this will bring to about twenty the total of HIPCs that have been covered by a ROSC. I would view this as a satisfactory pace of progress.

Mr. Usman asked whether there have been difficulties in ensuring good cooperation between the Fund and the Bank staff in this initiative. Ms. Gray will complement this, but for our part, we have found that after some initial discussion of how to structure the overall process of assessment and what could be the contribution of the two institutions in this respect, there has been very good cooperation in carrying out this assessment. There is a common view of what are the main remaining hurdles to improvement and reaching satisfactory standards in PEM systems, as well as agreement on the action plans to remedy the remaining weaknesses. We expect to continue to collaborate in meeting the needs of the countries concerned, not only with the Bank but also with other donors. In fact, one thing that I would note is that while the assessments have generally indicated that there are few remaining gaps in terms of needs that are unlikely to be supported by donors with technical assistance, an important task will be to ensure that the assistance provided by different donors is properly coordinated, in terms not only of avoiding overlaps, but also of providing consistent advice. In this sense, I would see an important role for the regional technical assistancecenters that the Fund is planning to open in Africa, where, in particular, the coordinating experts on public expenditure management can play a role in terms of promoting better coordination between donors. This is particularly important, because for many bilateral donors, decision-making is quite decentralized, and cooperation is best assured on the ground.

Finally, some of the Directors have raised the issue of why the staff is recommending that the next comprehensive review of the implementation of action plans by HIPCs be carried out by the end of 2004 rather than next year. The main reason for this is that we consider that sufficient time is needed to assess progress. A period of two years–in fact, a little less than two years, because most of the assessment will have to be completed by early 2004 to ensure that the deadline for the preparation of the paper and its discussion by the Board is met—is needed to take a comprehensive stock of the changes to date. However, this more comprehensive assessment would be supplemented by reports in the course of program reviews, especially where there are conditionalities linked to improvements in PEM systems in the program.

Mr. Yanase made the following statement:

In our discussion one year ago, there was total agreement that public expenditure management is essential for the HIPC Initiative, and that substantial efforts would be needed on the part of both HIPCs and the international community. We therefore welcome the follow-up Board papers which present the results of assessments of public expenditure management in many HIPCs. We thank the staff of the Fund and the Bank for their efforts. As expected, the results of the assessments are not very reassuring. They confirm the view that in almost all HIPCs, public expenditure management needs substantial improvement, and they also underline the urgency of the effort. Therefore, we are glad to see that in most of those countries, action plans have been prepared that include not only medium-term measures but also short-term—and in some cases interim—measures. We look forward to the incorporation of these action plans into PRSPs and country-specific strategies, and to their smooth implementation.

The Board needs to remain vigilant. We support the staff's intention to report on the progress in each country as part of the normal review of programs. We also support the proposal to undertake a comprehensive review of the progress by end-2004. It is clear that improvements in public expenditure management systems in HIPCs require assistance from the international community. We are heartened by the staff's assessment that there is no apparent shortage of assistance in this area. Still, in order to fill the remaining assistance gaps, the Fund and Bank staff are encouraged to play an active role by, for example, alerting donors to the existence of gaps on the occasion of CG meetings.

On the Fund's technical assistance, we support the current policy of focusing on areas essential for achieving macroeconomic targets. Given the Fund's limited resources, however, let us stress the importance of maximizing the efficiency of technical assistance . technical assistanceshould be fully prioritized through, for example, the PRSP process, according to individual countries' particular needs. It is also clear that upgrading public expenditure management system is a long-term agenda, and the international community should not expect quick results. We thus share the staff's view that assistance should not be reduced simply because the results of these assessments are not particularly satisfactory. However, the fiduciary responsibility of donors should not be underestimated. To respond to donors' legitimate concerns, HIPCs should do their best, including through the reintroduction of bridging mechanisms to track poverty-related expenditures. Moreover, we share the view of Ms. Lundsager and Mr. Dohlman that the paper overemphasizes the risk that donor support for system-wide approaches may be reduced.

On the issue of decentralization of poverty-related expenditures, we share the staff's view that progress in decentralization would make it harder to keep track of these expenditures. Given the lack of human and other resources in local governments, like Mr. Chatah and Mr. Bakhache, we are also concerned that decentralization may reduce the efficiency of these expenditures.

Finally, like many Directors, we would like to stress that the need to improve public expenditure management is in no way limited to HIPCs. How to apply the lessons learned from the HIPC Initiative exercise to other low-income countries will be an important part of our future agenda. We support publication of the papers after appropriate editing, believing, like Mr. Varela and Mr. Garner, that these papers will help other countries in their efforts to upgrade their public expenditure management systems.

Mr. Scholar made the following statement:

We very much welcome the staff paper, which is an excellent example of Fund-Bank cooperation, and we fully endorse the view on the importance of effective public expenditure management and accountability systems, which we see as absolutely essential to the effective delivery of aid, successful program design, and underpinning development more generally. This has been most useful in drawing attention to the scale of the challenge that faces many of these countries.

We agree that staff should include, where critical to the success of the program, conditionality on PEM, and we think that reviewing it as we go along through PRGF reviews and Article IV consultations and across the street in the Bank will be extremely important. We would like to see a continual monitoring of progress, and perhaps one idea would be to standardize that, perhaps through having a standard box in each PRGF review which would help us to keep track of it at an aggregate level as we move along.

The paper sets out a number of risks. We agree with others that perhaps the risk of donor withdrawal is not quite as great as it may appear there. We do, though, think that the scale of the challenge and the time that it takes to tackle it may, in fact, be rather longer than is suggested. There are some difficult issues about accounting, financial reporting, and dealing with local government that will take considerable time to deal with, but these are risks that have to be recognized and that have to be dealt with, and the best way to do that is to have a transparent debate, so we would very much support publication of the paper.

On the next review, we agree that a comprehensive review in 2004 would be useful, although like others, we consider that we must not lose track of this work between now and then, so what we would suggest is perhaps a year from now to have some kind of update which could be based on the standardized approach that we have suggested in program reviews, and it would be interesting to have staff's comments on that proposal.

Turning to implementation, on technical assistance, we welcome both the Fund's existing work, including through follow-up to ROSCs, and the proposal for an Africa regional technical assistancecenter. My authorities have some comments on the scope and the direction of that proposal which we will be discussing separately, but we very much hope that it can move forward. As a general comment on technical assistance, we do feel that we must give due weight to the need to enhance the skills and training of public finance professionals. In many countries, this can be often a more cost-effective way of taking forward technical assistance than providing new systems.

One final area which we would like to comment on is the issue of coordination. This is a work where very strong coordination between the Fund and the Bank is essential. While this coordination is well in hand, we consider that it would be useful to take stock of the broad sweep of PEM issues, not just confined to HIPCs, but looking more widely. We would like to propose, as in fact we have already done in our paper for the PRGF review, that for the annual meetings later this year, a joint Fund/Bank paper is prepared which sets out the overall aims and objectives of PEM work, which looks at the role of both institutions and the work that's already in hand, which covers both diagnostic tools and—very importantly— strengthens the link between diagnosis and implementation, and which identifies areas of overlap and possible gaps. As others have suggested, this could cover procurement, and it also might consider some of the broader political and institutional constraints on the quality of public finance management, such as pay of civil service, skills, civil service reform and transparency. These can be just as important as some of the more narrow and technical things that are covered here in delivering effective PEM. Finally, although this would not be the predominant focus of the paper, the paper might also look at the roles of other donors and how best the overall efforts of the international community could be coordinated. The Fund would have quite an important role to play here, particularly in its advice to finance ministries on priorities and sequencing. This would be quite a broad paper, but it is a very complex issue and we think a very important one. We would certainly welcome a stock take of this sort later in the year. Again, we would look forward to staff's views on that.

Lastly, we welcome the progress that is being made on ROSCs and thank the staff for the update that was just given, which indicates that in about eighteen months' time, 20 HIPCs will have been covered. That is very encouraging. We would also encourage as many countries as possible to publish these ROSCs in the interest of greater transparency and to strengthen the support for these very important reforms.

Mr. Andersen made the following statement:

I very much welcome this discussion. It is important to ensure that resources released through the HIPC Initiative are effectively used for poverty alleviating measures and in this regard, the tracking of poverty-reducing public spending in HIPCs is vital. Also, it is essential for securing continued support in the donor countries for the HIPC Initiative and the PRGF, and bilateral donors quite naturally have a strong interest in developments in this area as they gradually increase their budget support programs.

At the same time, one has to be well aware of the limitations in such analysis and to guard against the risk that assessments become excessively influenced by a narrow statistical approach. Needles to say, PEMs concern more than simply the accounting, auditing and monetary composition of budgets, and the assessments cannot be conducted by only applying quantitative benchmarks, especially when the benchmarks themselves are rather weak. Thus, questions of quality and sustainability in the implementation of benchmarks easily elude the analysis.

Furthermore, we find that the study would have benefited from a more in-depth analysis of the governance structure surrounding PEM decisions with special attention devoted to the efficiency and effectiveness of the decision making process, including how the parliament is involved locally in the budget process, as well as from an evaluation of the impact of other donors' ongoing support to the PEM and would like to emphasize the importance of coordination in PEM implementation.

After these general remarks, I would like to offer some comments on specific issues raised for discussion in the paper.

We are encouraged to note that in spite of some weaknesses in the PEM systems, progress has been made and that nearly all of the countries reviewed are seen to have the potential to make significant improvements in their PEM systems within a timeframe of 1–3 years. This timeframe should be flexible enough to allow countries under consideration to proceed at speeds commensurate with the available capacity in terms of resources and technical assistance. We urge the Bank and the Fund, and the local authorities to continue building and strengthening the PEM systems, which are essential for the monitoring of efficient use of scarce resources.

Concerning the action plans and strategies to improve PEM systems, we encourage the staff and the national authorities to work towards including these action plans in country owned documents such as PRSPs. Even though the medium to long-term measures will take longer to implement than the short-term measures, the implementation of all measures should start promptly, as they complement each other. It is important to have regular reporting on the progress of the action plans and follow-up reviews can, of course, be undertaken in the context of Bank-Fund supported programs. However, given that both the implementation and the monitoring of action plans are resource intensive and that progress in PEM systems only may become visible over a fairly extended period of time it would perhaps be natural to make such reviews a standard element in Article IV consultations in an initial phase. More generally, we support the continuation of the existing framework and division of labor between the Bank and the Fund. It is important that the Fund is satisfied that the main macro-economic objectives are adhered to, and we consider it appropriate that HIPC countries should fulfill their PEM triggers by their completion point.

Clearly there are risks involved as the staff describes toward the end of the paper. However, we find that the staff's approach may be somewhat too risk-averse while at the same time we are sympathetic to concerns of ownership. We find that the early development of efficient PEM-systems is instrumental in achieving macroeconomic stability in HIPC countries. This is in the own interest of the countries involved and it is important that donors work closely with the recipient countries to achieve progress in this area. The success of the whole PRGF ultimately rests on the success of public funds "saved" from debt service being used efficiently and measurably in areas of reducing poverty such as health, education and infrastructure. That is where we should keep our focus.

Tracking of poverty-reducing public expenditures is key both to the HIPC process and to the PRSP process, and considering the importance of this issue and that most countries are seen to be able to make significant progress within 1–3 years, I would have preferred to have the next comprehensive report in 2003. I have noted that some other Directors are on the same line and, with this in mind, I can go along with Mr. Scholar's useful suggestions, i.e. to have reporting in a standardized box in program review papers as well as an annual update.

Finally, I can support the publication of the paper following appropriate revisions in light of the discussion.

Mr. Guinigundo made the following statement:

I will touch on two major areas; one, on the objectives and underlying principles of the project; and, two, on moving the issues forward.

Clearly, the link between HIPC assistance and poverty reduction should be strengthened, and we cannot overemphasize that. It is also important that the budgets of low-income countries become increasingly pro-poor. However, it is extremely important to recall that we are dealing with efforts to improve public sector management as a whole in the HIPCs, and not simply putting in place mechanisms to monitor poverty-reducing spending so as to satisfy donors that their assistance has been utilized as programmed. Good public sector management is essential for fiscal discipline, planning, accountability, and—ultimately—for achieving sustained economic growth. We cannot overemphasize that economic growth is the key to making substantial inroads into reducing poverty. It is therefore important to ensure that efforts directed towards strengthening the tracking of public spending in HIPCs are not presented merely as to meet accountability demands, but as a key element in establishing one of the fundamental pillars for achieving sustained growth. It is for this reason that we associate ourselves with other chairs, particularly Mr. Cippà, Mr. Kelkar, and Mr. Al-Turki, who emphasized that it is highly appropriate for work on poverty-reducing public expenditures to be incorporated in mission work on existing programs. This is one important way of not only reducing the burden on both the authorities and the Bank/Fund resources, but also of ensuring that such an exercise is conducted in its proper context.

Following from these general remarks, we also affirm some fundamental principles laid down in the paper and mentioned by all the chairs and the speakers before me, notably, that it is not enough to monitor only HIPC assistance to the exclusion of other elements of public expenditure, that the enhanced HIPC Initiative should be shown to have led to an additionality in poverty reducing public spending, and that while this will require effective PEM systems, establishing these PEM systems will take time to bear fruit.

We would also like to suggest several points. Some of these points were also raised in some of the statements and by some of the speakers before me, and we would like to emphasize the following. First, there is a risk that parts of the development community may have unrealistic expectations about the pace of reform. It is understandable that these expectations and underlying concerns exist. Donors want a good handle on how their funds are being used, and they want to have confidence that poverty reduction objectives will actually be met. And there is also the issue of donor accountability to domestic constituencies. But these expectations should be balanced against the reality of the severe capacity constraints that the HIPCs face. Donors need to be realistic about their expectations.

Second, the donor community should also be prepared to provide significant technical assistance aimed at strengthening the overall PEM capacity, and allow sufficient time to develop robust PEM systems. It would be unfortunate and very premature to draw conclusions about progress and the effectiveness of assistance in this area based on the initial assessments. As the staff notes, institutional reform is a long-term process, and progress inevitably proceeds at varying speeds in different settings and over different time periods.

Third, ensuring country ownership of action plans is vital, and the Bank and the Fund can play a role in fostering a skills transfer approach and developing an action plan that aims to develop a sustainable country capacity. We should ensure widespread involvement of relevant stakeholders in the country, in line with the principles embodied in PRSPs. In particular, it is important that this exercise is not seen as one that is being imposed on HIPCs simply because donors are demanding accountability for their assistance.

Fourth, given the risks and the requirements of establishing strong PEM systems, we support the combination of short- and medium-term measures proposed as part of the action plans and strategies to improve PEM systems. This two-stage plan reflects the reality that while significant improvement is required to track poverty-reducing expenditures, changes will not be immediate. We also associate ourselves with the idea that the plan should begin by tracking all poverty-reducing expenditures and not just HIPC-related resources.

Fifth, in terms of the roles for the Bank and the Fund in strengthening PEM systems, we are encouraged that only small gaps in existing assistance have been identified. We should note that even distribution of benchmarks achieved across the three categories of formulation, execution, and reporting further supports the view that no one area has been neglected in past efforts to strengthen PEM. As such, we consider that the key roles for the Fund and the Bank will be to continue to place heavy emphasis on strengthening PEM capacity. It is clearly necessary for this work to be integrated into Fund- and Bank-supported programs and PRSPs. As the paper on the review of the PRSP approach clearly showed, PRSPs to date have sometimes included only broad references to the need to improve PEM systems, generally without sets of specific measures for doing so.

In conclusion, we wish to emphasize a broader issue. The broader issue is that public expenditure management should be at the heart of Fund-supported programs. In program reviews we have always focused on the need to improve public expenditure management and monitor progress in this area, and rightly so. It is not clear to us why at this point there is a need to conduct stand-alone comprehensive reviews on the tracking of poverty-reducing public spending. Is it not possible to extract something from existing exercises or even republish them and avoid taking the specific tracking of poverty-reducing public expenditure spending from the general thrust of improving public expenditure management? Maybe the staff can tell us the value added from a similar stand-alone exercise three years from now.

Mr. Nijsse made the following statement:

As we already concluded during last year's meeting, the fact that only nine out of twenty-four HIPCs have a satisfactory public expenditure tracking system is a reason for concern. A good budget implementation and control system is the basis for sound financial management in any country—as it also is in any enterprise or other organization.

Transparency and accountability remain vital for the credibility and public support for the HIPC Initiative. Furthermore, to reduce the administrative burden on HIPC countries, it should be avoided that donors track their individual bilateral contributions parallel to the country's own public expenditure management system. Therefore, a single common reporting system for all donors should be based on a good public expenditure management system which makes tracking of poverty-reducing expenditures possible.

I would like to stress again that tracking of poverty reducing spending should be included in the normal tracking and control procedures of the budget process. Virtual poverty funds are, at the most, a second-best option to earmark resources freed by HIPC debt relief for poverty-reducing spending. Those partial tracking systems should be replaced by a full-fledged public expenditure management system as soon as possible.

The improvement of public expenditure management systems should be an integral part of PRSPs and PRGF-supported programs. I therefore welcome the technical assistance efforts in this area and the attention to public expenditure management in PRGF-supported programs. Given the still large number of HIPCs with inadequate expenditure management systems and the limited progress since last year's review, like Mr. Cippà, I would advocate the inclusion of measures to improve the public expenditure management system in the conditionality of Fund-supported programs. Adequate expenditure tracking systems are crucial for obtaining external financing and to monitor the poverty reduction targets of PRGF-supported programs, and are therefore key to the success of the program. Furthermore, elements of public expenditure management could be included in completion point conditionality.

I am pleased to see that many donors are active in providing and financing technical assistance in this area. Like Ms. Lundsager and Mr. Dohlman, I think the IMF and the World Bank might have to play a coordinating role to avoid duplication, and I welcome Mrs. Ter-Minassian's remarks about the intention to use the African regional technical assistance center for this purpose.

Given the importance of progress in improving expenditure tracking in HIPCs and the interest of donor countries in achievements in this area, I think, like many other Directors, that the next review should be presented earlier than the end of 2004, given that this can be done with limited staff resources, and as part of the normal surveillance process. As mentioned by Mr. Scholar, maybe it would be a good idea to have, instead of a full-fledged evaluation in 2003, an annual interim update. Finally, I agree with the publication of the staff paper.

Mr. Djojosubroto made the following statement:

Tracking of poverty reducing public spending in HIPCs is necessary to ensure the use of the released resources as intended. In addition to assuring the donors, tracking and tagging will also help to safeguard the spirit of the HIPC Initiative in alleviating poverty.

However, expenditure tracking is not an easy task in most of the HIPCs. As most of the countries receiving HIPC assistance have weak human, institutional and administrative capacity constraints, the first and foremost need is to build such capacities in these countries.

Although staff's assessment has indicated modest progress in some of the cases, the majority of HIPCs still need to strengthen their capacity in budget formulation, classification, execution and reporting in order to effectively track the poverty reducing public expenditures. Such upgrading in the PEMs will also need a strong political will and commitment to ensure efficiency and transparency. Given the countries resource and capacity constraints, reforming PEM can be a long-term objective and, as such, the tracking mechanism should not be a prior conditions in releasing the necessary HIPC assistance.

We broadly agree with the short and medium term action plan to improve the PEM. Since countries may start such improvement from different points or levels, we need to be selective and realistic in suggesting methods and setting guidelines for strengthening and tracking poverty reducing public spending. Accordingly, in the short-run it will be better to tag selected poverty program in the budget and a readily usable 'before-after' approach can be an appropriate way forward consistent with the medium and long-term plans . A 'virtual' poverty fund can be used to tag and track poverty reducing spending until a comprehensive PEM system is established. Bridging mechanisms adopted by most HIPCs to cope with the weakness in coverage of government transactions, program classification, budget reporting and information systems are appropriate as an intermediate step before a fully developed and functional MTEF is set up. Well defined responsibility of government agencies involved in the budgetary process, strengthened ability of MTEFs, and full implementation of IFMISs are crucial to strengthen PEM capacity in budget preparation, execution and reporting. We support the substantial steps envisaged in the medium- to long-term strategies to strengthen the PEM systems.

On coordination, the effective tracking of poverty-reducing public spending could be best achieved through a collaborative effort of HIPCs, IFIs and international donors. We urge the Bank and Fund for a more proactive role in providing financial and technical assistance for capacity building and institutional reforms in HIPCs. While international institutions and donors can play a significant role in building capacity, the sharing of experiences and use of experts from some developing countries can also be a more practical solution than to go for the more sophisticated tools of PEM, at least in the initial stages. Since human and institutional capacities can not be built overnight, a gradual approach of balancing capacity, quality and speed would be preferable. Staff report has mentioned a number of bilateral and multilateral donors providing assistance in PEM and in this regard we share the views of Mr. Chatah and Mr. Bakhache on the need of close coordination among the providers of technical assistance. Besides coordination, we need to be mindful of the additional cost associated with the technical assistanceprovided by the donors. In many cases, HIPCs have to allocate certain amount of their budget as the counterpart to the technical assistance .

On risk, we agree with staff that the assessment and action plan faces many risks. As we are dealing with countries having various capacity constraints, we can not totally disregard the risks. Risk can be minimized with the proper implementation of the reform measures. We agree with Mr. Cippà that progress in implementing the program would substantially enhance the credibility of the initiative and would lower the risk of donor's support. We believe that uncertainties and risks in improving PEM systems could be resolved through a good understanding between the HIPCs and the donors. In this context a better alignment of donor assistance is necessary with the intended goals of overall poverty reduction.

Lastly, we agree with the publication of the report and support Ms. Lundsager's view that it should reflect Fund Board discussions.

Mr. Haupt made the following statement:

Like other speakers, we welcome this follow-up report on this very important subject. The analysis and results provided are clear and to the point. The key finding of the assessment, namely that almost two-thirds of the sample countries require substantial upgrading in their expenditure tracking systems, clearly underlines the urgent need to seek improvements in this area. I take the staff's word of caution against using the assessment instrument for cross-country comparisons. However, lessons should be drawn from the experience made in the various countries. For example, it must be asked why Ghana only meets one of the 15 benchmarks in the assessment. On a specific point regarding these benchmarks, I noted that the category of budget reporting focuses mainly on issues of timeliness. It may be that the accuracy of budgetary data is also somehow covered in this category, but perhaps this dimension could be defined in more detail in the assessment methodology.

This chair broadly agrees with the action plans and strategies proposed by the staff. We reaffirm our support for the basic principles outlined in section II, especially the principle of country ownership for reporting on poverty-reducing public spending. A particular concern is the need to strengthen budgetary management capacities at the decentralized level. This will require strong country commitment as well as appropriate support of the donor community. As regards short-term mechanisms for tracking, such arrangements must not distract countries from working on the establishment of more effective long-term PEM systems. More generally, it is clear that the establishment of administrative capacities is a time-consuming process. In view of the importance of adequate expenditure tracking for the success of the enhanced HIPC Initiative and the PRSP process, however, an appropriate degree of ambition is called for. In this connection, I note Staff's assessment that, with some effort and commitment, most HIPCs can significantly strengthen their PEM systems within the next 1–3 years. We agree that such a timeframe should indeed be achievable.

In terms of the role of the Fund, the ongoing delivery of technical assistance is of great importance. Also, the focus on public expenditure management in current PRGF-supported programs and the proposal to report on the implementation of action plans in the context of program reviews are, in our view, appropriate. As is suggested in paragraph 44, the present assessment should provide some useful insights on how to further improve the conditionality of some programs.

Furthermore, we welcome efforts of the Bank and Fund and other donors to cooperate as much as possible in strengthening countries' budget and accountability frameworks. There is an agreed division of labor between the Bank and the Fund but these issues are not always well understood outside the IFIs, including in the countries concerned and the wider donor community. Overlap and duplication is likely to undermine progress, and places an excessive burden on HIPC governments. Against this background, we would, like the US and Dutch chairs, endorse a more proactive—but also a more transparent—role of Bank and Fund at the country level in coordinating respective donor activities, including through Consultative Group meetings. In this regard, I see merit in Mr. Scholar’s suggestion to produce a joint Fund/Bank report on PEM and tracking requirements which takes stock of existing initiatives and provides proposals for a more harmonized and coordinated approach.

Finally, like many other speakers, we would welcome adequate monitoring of the PEM action plans, be it through an update in a year’s time or by bringing forward the next comprehensive follow-up report to, say, end-2003 or early 2004.

Lastly, we support the publication of the paper.

Mr. Josz made the following statement:

Reliable management systems for public expenditures are crucial not just to ensure that the resources freed by the HIPC Initiative are directed to poverty reduction, but that all public resources are spent efficiently and transparently as called for by the budget. Like Mr. Al Turki and other Directors, I am glad that the Bank, the Fund, bilateral donors, and the recipient countries are united in the effort to make all public expenditures, and not just those aimed at reducing poverty, transparent and efficient.

Figure 1 confirms last year's suspicion that all of the Heavily Indebted Poor Countries still lack reliable systems for public expenditure management (PEM). This is a bad surprise given the large amounts of financial and technical assistance poured for decades into correcting such basic weaknesses in governance. The limited progress of the past year has at least led to a better understanding of the difficulties of designing and operating reliable systems for managing public spending in poor countries. Today's supplementary paper assessing the weaknesses, remedial actions, and remaining technical assistance gaps of each country will help them make the best use of local efforts and external support for improving their PEM.

Efforts to improve PEM should be a major concern of PRSPs and PRGF programs. The emphasis in PRGF programs of conditionality aimed at improving expenditure management is fully consistent, despite Mr. Usman's reservations, with the on-going streamlining of Fund conditionality. Effective management of public expenditures is a sine qua non for the success of Fund supported programs. I support Mr. Scholar's suggestion of a systematic focus on PEM, and for a specific report to ministers on these issues during the Annual Meetings. I also agree with Directors who seek more clarity concerning the division of labor between Fund and Bank on these issues. Last year, I suggested that the Fund should continue assisting ministries of finance in their efforts to improve the budgetary process. The Bank should assist other ministries to improve budget procedures, and the ministry of finance in installing computerized information systems compatible with the Fund's advice. The World Bank, of course, should continue to help countries assess the effectiveness of their public spending on education and health, which are key ingredients of poverty reduction and growth. Reactions from the staff would be welcome.

Finally, reliable systems for managing public spending in poor countries are absolutely necessary to convince public opinion in donor countries of the need to increase official development assistance. We should therefore adopt the proposal of Mr. Barro-Chambrier and Mr. Cippà to review, in 2003 rather than 2004 as proposed by the staff, the progress being made in improving these systems.

Mr. Wei made the following statement:

At the outset, let me thank staff for the well-prepared paper and the comprehensive background materials. The clear statement on the remaining gaps in the public expenditure management systems (PEMs) constitutes building blocks for defining the work ahead. While we appreciate staff’s contribution and the efforts already made by the concerned authorities, as staff indicates, the findings in the background paper underscore the importance for the HIPC authorities to take additional steps to further improve PEMs. However, given the countries’ variety in their stages of development, particularly taking into account the weak institutional capacity of many of them, we share the view that a gradual approach to establishing acceptable PEMs, as elaborated in Mr. Dairi’s preliminary statement, is most appropriate. Since we broadly share the views put forward in the preliminary statements, I will make the following brief comments on the key issues as raised in the paper.

First, we are of the same view that while the importance of strengthening PEM should be emphasized, we must remember that the authorities should adopt a holistic approach in designing a poverty reduction strategy. Furthermore, it is more realistic and effective for the authorities to deal with PEM related issues in the general context of the overall improvement of budgetary and public expenditure management. Strong ownership is essential if the authorities are to make the PEM function better. In this regard, we agree with others that the final solution in terms of enhancing PEM is dependent on the authorities whose efforts should be assisted by increased financial support from the international community.

Second, most HIPCs face constraints in their institutional capacity. To improve PEM, particularly to improve the institutional capacity for this purpose, may cost HIPCs much in terms of resources and take considerable time. Hence, we encourage staff to assess the cost and help mobilize the necessary technical and financial assistance from various sources. Given the considerable time needed, we caution against making the PEM improvement a binding condition for HIPCs.

Third, we share the view that burdens on the authorities and costs to the Fund arising from PEM assessment should be carefully evaluated and, in turn, minimized. Given human resource and institutional capacity restraints, too frequent assessments and reviews could be exhaustive. Therefore, we think it appropriate to conduct the next comprehensive review in 2004.

Finally, on the issue of Bank and Fund collaboration, Mr. Usman raises a number of concerns in his very helpful preliminary statement which deserve our full attention, in particular the cost of technical assistanceas well as the issue of the staffs of the two institutions providing the authorities with consistent policy advice.

We support the publication of this paper after it has been revised in light of today's discussion.

Mr. Boitreaud made the following statement:

I join other Executive Directors in welcoming today's discussion, and I thank the staff for their valuable work. Public expenditure management is a fundamental issue, not only for the success of the HIPC Initiative, but also as an essential element to ensure the effectiveness and sustainability of poverty alleviation policies. Many of the points I wanted to raise were covered by Directors in their statements and by previous speakers. In particular, we share the point made by many Directors on the temporary nature of the bridging mechanisms, such as the virtual poverty funds, and the necessity to establish comprehensive tracking mechanisms for all poverty reducing spending in order to preserve the unity of the budget.

In addition, the strengthening of public expenditure management systems should be better incorporated in the PRSPs to demonstrate clear ownership. We would also emphasize the importance of strong coordination between the IMF and the World Bank on technical assistance. Prioritization of areas of technical assistance is needed not only to take into account a country's specific situation and needs, but also in accordance with the nature and scope of support provided by other donors in these fields. Also, we agree that the action plan on these matters should be integrated in the Bank and Fund-supported programs and that progress on these action plans should be reported as part of the normal review process.

On the risks highlighted by the staff in the paper, we share the view expressed by Ms. Lundsager and Mr. Dohlman that the paper tends to overplay the risk of a reduction in donor support for a system-wide approach. We believe that providing a clear picture of the weaknesses and shortcomings and defining well targeted action plans will contribute to enhance a country's chance to tap into increased budgetary support. We also believe that the nature of donors' contributions need to be tailored to a country's specific circumstances, and that paragraph 61 probably needs to be more balanced to reflect this.

We agree with the staff that the report should be published. Finally, given the essentiality of this work, we would favor the completion of the next review as early as possible. In the meantime, we support Mr. Scholar's proposal for an update next year.

Mr. Vermaeten made the following statement:

I thank the staff for providing this follow-up paper, and in light of the comments already made, I only have a few brief comments and questions.

First, there seems to be no shortage of supply of technical assistance for strengthening public expenditure management. Given the significant technical assistancethat is being provided, we are concerned that greater strides have not been made towards improving PEM. Perhaps one of the things hindering progress is the high turnover rates of local staff, which may be diminishing the effectiveness and the long-term benefits of such technical assistance. In some countries, the high rates of HIV/AIDS infection could also aggravate the situation. Do the staff have views on how developing countries can better and more effectively lock-in the gains made from technical assistance?

Second, given the volume of technical assistance, effectiveness could perhaps be improved if the Fund and Bank staff took a stronger role in securing and coordinating donor assistance in this area. In this respect, annual updates of the comprehensive report on PEM, as suggested by Mr. Scholar, would be useful in this coordination role. A joint IMF-World Bank paper taking stock of technical assistance could also be very useful for this purpose.

Third, as mentioned a number of times, increased decentralization complicates public expenditure management. Could the staff provide further comments on the type of capacity building initiatives that are being undertaken to strengthen PEM for subnational governments?

Finally, we support publication of the paper.

Mr. Lissovolik made the following statement:

We thank the staffs of the Fund and the Bank for a well-written set of papers on actions to strengthen the tracking of poverty-reducing public spending. We generally agree with the findings concerning the PEM systems of HIPCs, and accordingly we will concentrate on some of the key questions posed in the staff report.

First of all, we note that one of the gaps in the framework delineated by the staff may have been the lack of clarity on how individual countries are to effect a transition from the short-term arrangements such as bridging mechanisms to the more durable PEM systems that are to ensure adequate tracking of poverty-related spending in the longer term. In this respect we agree with Mr. Junguito, Mr. Varela and Mr. Boitreaud that short-term measures need to be consistent with longer-term objectives in this sphere. With regard to the action plans proper, we concur with Mr. Usman that greater attention needs to be accorded to the execution of the budget in view of the relatively weaker performance in this particular sphere exhibited by the HIPCs.

We agree with the staff that an important element in ensuring strong ownership of the improvement of the PEM is the active participation of civil society in monitoring fiscal outcomes. This in turn calls for a close integration of the PEM-improvement process with the formulation of the countries' respective PRSPs.

On the pattern and scope of Fund and Bank support, we agree with Messrs. Zocalli and Maino as well as with Mr. Haupt that there is a need for close cooperation between the IMF and the Bank to avoid duplication and effectively address the remaining gaps in assistance. Apart from Fund coordination with other multilateral agencies and organizations, it is equally important to harmonize and reconcile Fund's own operations with the objectives of poverty reduction and PEM improvement.

In this respect, like Ms. Lundsager and Mr. Dohlman we see notable potential in using the ROSC framework for contributing to the building of superior PEM systems in HIPC countries. As noted by Mr. Kelkar and Mr. Chatah, close attention needs to be paid to fiscal decentralization and local capacity building, as well as other fiscal developments (for example the expansion of extra-budgetary operations) that may have significant bearing on the process of improving PEM systems in HIPCs. Finally, we concur with the observations made by Mr. Cippà that conditionality related to public expenditure management should be effectively incorporated into the completion-point triggers going forward. More generally, we believe that staff should report on progress in implementing action plans as part of the normal review of Fund-supported programs.

With respect to the risks outlined in the staff report with regard to the action plans and their implementation, we agree with Ms. Lundsager and Mr. Dohlman that the risks of lower donor support due to assessment results are overstated. A far greater risk resides in the stalling of the PEM-enhancement process, which would certainly be a negative signal to the donor community.

We agree with Mr. Cippà that the next comprehensive report on the implementation of action plans by HIPCs to strengthen the tracking of poverty-reducing public spending should be provided well before the end of the year 2004 date suggested in the staff report.

Lastly, we agree to the publication of the paper.

Mr. Sdralevich made the following statement:

We would like at the outset to thank the staff of the World Bank and the Fund for the follow-up to this crucial HIPC Initiative topic. Tracking and management of anti-poverty spending should be seen as an integral part of the HIPC Initiative anti-poverty effort. Debt relief itself is justified by the need to reduce the widespread and deep levels of poverty in HIPC countries. The issue whether expenditures made possible by the HIPC Initiative are effective in fighting poverty is therefore central. It is clear such effectiveness depends in the first place on the transparency and efficiency of expenditure planning and execution. In the second place, poverty spending must have the highest possible impact on poverty indicators. While this is not the focus of the papers, we agree with staff that this kind of analysis should in perspective be incorporated in PRSPs. Let me comment on the paper results, the proposed remedies, and assistance.

With regard to the results of the analysis, the overall final assessment in the follow-up papers confirm the findings of the preliminary work There is no need to go into details, given our comments on occasion of the previous Board meeting. We have to stress again that the emerging general message is that there is much to do. Incidentally, we share Mr. Kappa’s comments on the need to link, at least in some cases, completion point and PRGF conditionality with poverty expenditure management. We would also tend to agree that a review of progress in poverty expenditure management should be carried out before 2004, but having heard Mrs. Ter-Minassian's remarks, we can go along with Mr. Scholar's compromise.

We would like here to underline three pieces of evidence from the analysis that are perhaps most troubling. First, almost 90 percent of countries lack effective internal audit procedures, reflecting insufficient transparency and accountability. Second, there is widespread disconnection between the relative sophistication of PRSPs and the ability to relate poverty spending to their specifications in a medium-term framework. Third, devolution is making tracking more difficult. In this regard, we wonder if advice from IFIs in the field of devolution is consistent with an effective fight against poverty. Comments from staff would be appreciated.

With regard to the remedies, we agree that it is essential to take immediate action to correct the shortcomings of the current tracking systems emerging from the follow-up research. We agree with the dual short- and medium/long-term approach taken by the concerned countries and presented in the staff papers. We have three observations here. First, we agree that tracking systems should work on the totality of poverty expenditures, not only those strictly HIPC-related. Since money is fungible, the overall effort against poverty should be taken into consideration to evaluate the impact of HIPC debt relief. Second, in implementing these remedial actions, country ownership is paramount, and cannot be substituted by donors' or IFI assistance, however extensive. Third, we believe that perhaps more should be done on the front of accountability of poverty expenditure planning and execution. In this context, transparency and accountability must be seen as complementary to the participatory process which is a centerpiece of the HIPC Initiative. Continued participation of civil society cannot take place without full information and two-way consultations on poverty spending.

With regard to assistance, we are comforted by the level of donors' assistance to the process of tracking poverty expenditures. However, we agree that the Bank and Fund staffs should take up a more proactive role in coordinating donor activity to maximize the impact of all initiatives in this field.

Lastly, we agree with the publication of the papers.

The Director of the Fiscal Affairs Department (Ms. Ter-Minassian) made the following statement:

Let me comment first on a couple of more general issues that have been raised by Directors, particularly as concerns the effectiveness of technical assistancein the PEM area and the possible tension between decentralization and ensuring effective tracking of poverty-reducing spending.

I would agree with a number of comments made by Directors that the record of effectiveness of technical assistancein the PEM area for HIPCs leaves a lot to be desired, which probably calls for more formal evaluation of the reasons for this. Personally, I believe this should be part of FAD's work program over the next year or so. But let me offer some considerations based on the experience that I have had during the last year in this respect. In my view, one main reason is that there has been lack of country ownership for the technical assistance . We hope that the action plans which have been thoroughly discussed with the authorities, based on a shared assessment of weaknesses, will help to remedy this situation, and that countries will take ownership of the reforms that they have committed to. In some cases, the high turnover of local, and in other cases, changes in government—Ghana is a good example in this respect—may have contributed to the loss of continuity in the implementation of technical assistance . Also, in a number of cases, there have been problems of coordination with other donors, leading to conflicting advice or gaps in assistance. Finally, perhaps there was not enough preparedness on the part of the staff to stop technical assistancewhen it was clear that it was not being effective, and not sufficient emphasis on the track record of countries in the implementation or in the effective utilization of technical assistance. I believe that both the increased transparency in reporting on progress in the implementation of the action plan, and the fact that the action plans themselves have been thoroughly discussed with the authorities and hopefully will be reflected in PRSPs should help improve the track record in this respect. So should the increased coordination that we hope to be able to carry out on the ground with other donors. But clearly, I agree with the remarks of a number of speakers that we need to continue monitoring closely the progress in the implementation of the action plans.

As regards the question of the possible tension between decentralization and the effectiveness of management of the expenditures for poverty reduction, I would agree that in most cases, there is such a trade-off. The staff has stressed on a number of occasions the importance of ensuring the pace of decentralization does not run ahead of the capacity of local authorities to implement effectively the expenditure responsibilities that are being delegated to them. This also implies the need for technical assistance by bilateral donors, the World Bank, and—within the very limited resource envelope that we have in this area—the Fund, to support capacity building at the local level. As far as FAD is concerned, we have been involved in providing on an occasional basis assistance to sub-national governments. We have also been involved in providing assistance to central governments in designing decentralization strategies that aim at strengthening not only expenditure management capabilities, but also, in line with the Fund's mandate, fiscal sustainability and fiscal responsibility at the sub-national level.

On the request for continued monitoring of progress in the implementation of the action plans, I agree with Mr. Scholar's proposal that a box reporting on the progress made could be included on a systematic basis in reviews of PRGF-supported programs and Article IV consultation documents. I also agree that FAD could prepare an update by the end of next year, based on such documentation. What I cannot agree to, given the resource constraints that we have, is to embark in the course of next year on a comprehensive review such as this one, which required five man years in the past year, while there are about twenty man years of staff in the public expenditure management area. this. If needed and wished for, an update in 2003 based on the information reported in the area department documents could be an acceptable compromise.

As regards the more general paper on collaboration with the Bank in the provision of technical assistance, I would say that the Bank has begun an effort under the public expenditure and financial accountability framework to streamline the various instruments that it has for analysis and delivery of assistance in the PEM area. We collaborate with them in this effort through the participation of FAD in the steering committee, and part of the work of this committee is to look at how Bank instruments can best be coordinated with Fund instruments, including ROSCs and other forms of technical assistancein the PEM area. I believe that it would be slightly premature to present a paper on this by the time of the next annual meetings, particularly considering that there are limited resources— at least as far as the Fund staff is concerned. Our specialized resources in the PEM area need to be deployed to support the implementation of the action plans for HIPCs, while at the same time attending to the substantial demand that we receive from other PRGF countries in this area.

The staff representative from the World Bank (Ms. Gray) made the following statement:

With regard to Mr. Usman's questions on technical assistance and the different modes of delivery in the Bank and the Fund, I would like to point out that we have complementary instruments in the Bank and the Fund. They are not directly competitive. The Fund supplies people with real expertise and skills, almost on a retail level, to give advice to governments. We do not provide the same kind of retail level technical assistance. The Bank has a lending instrument for assistance in areas such as financial management, information systems, and other types of institutional reforms. The Bank lends US$2 to 3 billion a year for technical assistance, and there is no option for giving that away free. We certainly do not want to crowd out grants. In fact, the Bank also has the institutional developmental facility grant mechanism, which has about US$20 million a year in grant money for technical assistance, half of it now dedicated to public expenditure management work, the other half to legal and judicial reforms in the area of governance. Therefore, we provide a considerable amount of lending for technical assistance, much of it on IDA terms, which has a large grant element in and of itself. The instruments of the two organizations are highly complementary, and our working relationship with the Fund over the last year has been very good, with all of our staff having benefited from the experience. We have come much closer together, and I hope that this will continue.

Second, I also wanted to underscore the comments of some of the Board members on the question of effectiveness of technical assistance and governance. In the Bank, we very much consider that the effectiveness of technical assistance largely depends on the environment in which it is provided, and the underlying demand for reform and for change. Some of those factors are still outside the control of the technical assistance providers, and the Bank is trying very hard to work on the broader governance environment as part of its technical assistance work. In fact, we are preparing a review on our governance work over the last three years which will be given to the Board a month from now. We discuss the questions of the effectiveness of our governance work, the direction we are going in, and how we try to boost the supply of assistance as well as stimulate demand for reform in the countries in which we are operating, because the two really go hand in hand. Therefore, I strongly agree with the importance of the underlying governance environment, and that the effectiveness of technical assistanceis not simply a technical question of how it is delivered.

I am glad that Ms. Ter-Minassian mentioned the PEFA program. We are working with the European Union that has given a large trust fund to work with us. We have also received money from the development grant facility in the Bank. The DFID is involved, and several other bilaterals have expressed interest. This means that we now have a mechanism to streamline our assessment work, and to develop common tools to share information, because all of us feel the same pressures to do better in the area of technical assistance, both for fiduciary and for development reasons. The mechanism is still in its early days, but we already have made considerable progress, and we are moving forward.

Regarding our future work, I think the idea of having a box in our documents on PRSCs and CASs is a very good one. I hope that will come up in our Board’s discussion tomorrow. A report at the end of next year pulling together the information contained in those boxes would also seem feasible. I very much agree with Ms. Ter-Minassian that we would like to stick to 2004 for the next comprehensive review. It is worth bearing in mind that we literally have been working one year on the preparation of this paper, with twenty-five missions and a tremendous amount of work. We would rather wait a little, let the work continue, ensure that it is reported on a regular basis in the context of reviews of Bank- and Fund-supported programs, and then carry out another big effort in 2004. We certainly do not want to lose sight of the action plans, and they are already very well integrated into the lending programs and assistance strategies of the Bank country teams.

I would also like remind you, with regard to the question of a separate paper for the annual meetings, that last year, we sent to our Board a detailed review outlining all of the Bank's work on public expenditure management over the last 20 years, as well as what we are currently doing. So we can see where we want to go from here, but I think there has been quite a bit of information that has already been pulled together.

Mr. Josz thanked the staff of both the Fund and the World Bank for their clarifications. However, it was still not entirely clear how the work was divided between the Fund and the Bank in the area of public expenditure management systems, and he wondered whether it was correct to assume that the Fund focused on the overall procedures linked to the budget that needed to be approved by Parliament every year, dealing mostly with the finance ministry, whereas the Bank dealt with the budgetary procedures of the other sectoral ministries, as well as the more detailed work linked to information processing, including for the finance ministry.

The Director of the Fiscal Affairs Department (Ms. Ter-Minassian) indicated that in the case of HIPCs, the Fund had focused on budget classification and improving control mechanisms, particularly in the areas of budget execution and treasury management reporting. The staff also worked on broader strategies of reform in the public expenditure management area, always in coordination with the Bank, and with greater emphasis on the upstream activities linked to technical assistance. The staff tried not to get excessively involved in the implementation of integrated financial management information systems, although that had been done on a few occasions, for some countries in the former Soviet Union and some countries in Latin America. In general, the emphasis—particularly with regard to HIPCs—was on trying to give those countries the tools to enable them to better identify and report on the execution of expenditures which were poverty-reducing spending, according to the PRSP definition.

The staff representative from the World Bank (Ms. Gray) remarked that the Bank's work covered all the budget formulation processes of the Ministry of Finance. It also centered on medium-term expenditure frameworks and budget forecasting, working with the finance ministry and the sectoral ministries in order to put in place a process that was transparent and open, weighing trade-offs, and forward-looking. Through its public expenditure reviews, the Bank also focused on analyzing different types of expenditure allocations and particular aspects such as civil service reform or decentralization. The Bank was also devoting more resources to expenditure tracking surveys, going on the ground to see how much money was reaching service providers, schools, and hospitals, thus bringing accountability into the process. In addition, the Bank was also working more with supreme audit institutions and parliaments. The Bank's topic coverage was therefore rather broad, and the lending and the analytic instruments were complementary in many ways. Generally, though, it was not really appropriate to characterize the Fund's work as being centered on the finance ministry, while that of the Bank was focused on the sectoral ministries, especially given that the processes were completely interconnected.

Mr. Kelmanson said that he was grateful to the staff for their thorough responses to the statements and the discussion, and that he welcomed the commitments that had been made on reporting through program reviews, in a standardized way, on the progress made against the action plans. This effort would provide the material for an annual update in about one year's time, which should not be too resource intensive and would allow the Board to come back to the topic under consideration earlier than 2004. He was also very interested in Ms. Ter-Minassian's comments about the effectiveness of technical assistance in the fiscal area, and looked forward to the results of FAD's work in that respect.

On the issue of a joint report between the Bank and the Fund staff, Mr. Kelmanson indicated that there were still a number of Directors who had raised instances in the past where the Bank and the Fund had provided advice that was not necessarily consistent in the area of public expenditure management. The Bank and the Fund addressed this issue from slightly different perspectives and possibly with slightly different paradigms, and with a large variety of diagnostic tools. While it was very important that the Bank had begun to streamline its own interventions and analytical tools, there was also great value in doing so in a holistic way, in both institutions, in much the same way as had been done with the conditionality review. This called for a joint piece of analysis, pulling together information from the Bank's and the Fund's perspective, which would then be discussed by both Boards. Although timing was a valid concern, given the capacity constraints within both institutions, it still seemed preferable to prepare such a paper by the time of the next annual meetings. Nevertheless, the principle of such a discussion was more important than exactly when it occurred.

The Director of the Fiscal Affairs Department (Ms. Ter-Minassian) agreed that such a paper would be interesting and valuable, but wished first to see some more progress in the context of the PEFA framework, some more reflection on the various instruments used in the PEM area, and some more analysis of the effectiveness of technical assistance. She was reluctant to commit to a timetable as tight as the annual meetings, given the serious capacity constraints, at least with regard to the staff of FAD working in this area. It was also worth bearing in mind that there was a clear trade-off between direct delivery of technical assistanceand such an effort.

Mr. Vermaeten wished to say in support of Mr. Kelmanson that the sooner a paper looking at how best to coordinate technical assistance would be ready, the more effective technical assistance could be.

Mr. Josz said, on the issue of the dividing line between the work of the Fund and the Bank, that the description provided by the staff representatives gave the impression that there was some crossover in the work of both institutions, especially in the area of budget formulation. He wondered what mechanisms were in place to ensure that the advice of the

Bank and the Fund was consistent, and to avoid the problems to which Mr. Usman had alluded in his statement.

The Director of the Fiscal Affairs Department (Ms. Ter-Minassian) remarked that, in her opinion, the Fund and the Bank did not have fundamental differences of view on budget formulation techniques. While the Bank focused more on policy issues in the expenditure area and on medium-term budget frameworks, the Fund normally focused more on transparency issues and on improvements in the budget formulation process in the context of the short-term macroeconomic projections and framework. For example, in the context of the public expenditure reviews, the Fund focused more on the process and, in particular, on aspects of transparency in budget formulation. In addition, matters related to budget classification, execution and reporting, and the quality of data, were the special focus of the Fund's technical assistance. With a few exceptions, the Fund had not been involved in downstream activities which normally needed to be supported with lending operations, such as the implementation of integrated financial management information systems.

The staff representative from the World Bank (Ms. Gray) remarked that the methodology behind the paper under consideration had been very helpful, because in every country the Fund and Bank teams had considered the results of the assessment and the action plan together, whether the Fund team or the Bank team was in the lead. A coordination mechanism had thus been established. Beyond that, given that there was no fail proof mechanism to ensure that there would be no duplication or overlap, the staffs of both institutions would have to continue to make progress, and the PEFA program would help considerably in that respect.

The Acting Chair made the following summing up:

> Most Executive Directors agreed with the assessment of the capacity of 24 HIPCs to track and report on poverty-reducing spending. They emphasized that HIPCs should track all poverty-reducing public expenditures (and not just spending financed by HIPC assistance) to ensure the additionality of resources allocated to such spending. The Poverty Reduction Strategy Paper (PRSP) should identify relevant poverty-reducing spending for tracking purposes. Directors noted that this approach should be adopted for all PRGF-supported programs. Efforts to improve the tracking of poverty-reducing spending should in principle be part of the broader and more comprehensive public expenditure management (PEM) reforms.
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> Directors also agreed that the ultimate responsibility for reporting on poverty-reducing public spending lies with the country. They were pleased that sixteen HIPCs are already reporting on poverty-reducing spending that is broadly consistent with programs identified in their PRSPs. They noted that of the 24 countries included in the current assessment, nine were found to require some upgrading to be able to track poverty-reducing spending satisfactorily, while the remaining fifteen required substantial upgrading to do so. Some Directors were concerned that weaknesses highlighted by the assessments

could reduce donors' budgetary support to HIPCs, while other Directors were of the view that such a risk was exaggerated in the staff paper. Collaborative efforts to strengthen PEM systems represent the best way to ensure accountability in the use of donor funds as well as of domestic tax revenues.

Directors endorsed the action plans that have been agreed with HIPCs to strengthen their capacity to track poverty-reducing spending in the short- and medium-term. They urged HIPCs to move swiftly to implement short-term measures, such as broadening the coverage of government accounts, upgrading budget classification, and more frequent reporting of budget outturns. A few Directors suggested that the provision of general budget support by donors will depend on the progress in strengthening PEM systems. They also encouraged HIPCs to implement bridging mechanisms that would allow immediate tracking while PEM systems are being reformed. Where necessary, countries should implement "virtual" poverty funds, which entails tagging and reporting on expenditures identified as poverty-reducing.

Directors noted with satisfaction that 11 of the HIPCs have already established, or are in the process of establishing such mechanisms. They stressed that these short-term measures should be consistent with longer-term reforms to strengthen PEM systems. Several Directors also underscored that the PEM effort should be designed to minimize additional burdens on the limited administrative capacity of HIPCs.

Given the growing trend toward decentralization in HIPCs, and the relatively weaker expenditure management capacity at the local level, Directors were concerned that the tracking of poverty-reducing spending is likely to become more difficult and require substantial institution building assistance over time. In this regard, they recognized that some HIPCs were addressing this issue in their action plans and that the World Bank is already providing assistance in this area to half of the 24 HIPCs. They urged other HIPCs to address this issue as a priority, and seek assistance as needed from the World Bank and other development partners.

Directors supported continuation of the existing role, scale and pattern of Bank, Fund and bilaterals' support to HIPCs. They noted that only a relatively small number of gaps in assistance were identified. They stressed the need for continued donor support for implementing the countries' action plans, including through technical assistance, especially to develop skills of officials in financial management. As specific activities and instruments of the Bank and Fund were seen as largely complementary, the Fund should continue to focus its assistance on strengthening macrofiscal management, including through the upgrading of budget classification systems, and expenditure commitment control mechanisms and treasury reforms aimed at improving budget execution and reporting. Bank assistance should continue to focus on institutional capacity-building across the full range of the PEM system, including information management systems. Directors emphasized the need to strengthen further the collaboration between the Fund and the Bank, as well as the coordination with donors, with a view to improve the effectiveness of their work on PEM issues, including through technical assistance. In that context, they also looked forward to the preparation, at an appropriate time, of a joint Fund/Bank paper on the overall aims and objectives of activities in the PEM area, in order to bring greater clarity to this work.

Directors urged HIPCs to integrate the action plans to strengthen PEM capacity in the short and medium term into their PRSPs or other country-owned documents. This will enable them to better catalyze donor and other assistance. For countries that have already produced a full PRSP, periodic progress reports would provide an opportunity to review progress in PEM reform and address any emerging issues. Directors agreed that the staff should address donor coordination issues on a country-by-country basis.

Recognizing that the reform of PEM systems is a long-term endeavor that requires sustained commitment, Directors acknowledged that there are certain risks in the approach outlined by the staff. The action plan may not be supported by all relevant stakeholders in a HIPC, or the capacity to implement technical assistance programs may be weak. They noted that countries' starting points vary and that institutional change takes time. Directors encouraged the staff to be vigilant of these risks and to provide additional technical support to countries whenever necessary within resource constraints. In this context, Directors agreed that the staff should continue to report on progress in implementing PEM reforms envisaged in action plans as part of the normal review of Bank- and Fund-supported programs. They suggested that such a report take the form of a standard box in the program review documents. Directors stressed that all PRGF-supported programs should draw on PRSPs for PEM reforms.

While many Directors agreed that the staff should carry out the next comprehensive review of HIPCs' capacity to track poverty-reducing public spending in 2004, several Directors suggested that an annual update based on the standardized reporting in program reviews would be useful. Directors looked forward to the first annual update in 2003. In the context of reviews of Bank- and Fund-supported programs, the staff should also continue to report on data on poverty-reducing spending, as defined in PRSPs, and to the extent available.

Finally, Directors agreed to the publication of the staff paper, together with the PIN summarizing the Executive Board's discussion. They encouraged the authorities to use the individual assessment and action plans to seek international support for their reform efforts.

4. AZERBAIJAN REPUBLIC—2001 ARTICLE IV CONSULTATION; AND POVERTY REDUCTION AND GROWTH FACILITY—REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA

Documents: Staff Report for the 2001 Article IV Consultation, First Review Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria (EBS/02/21, 2/6/02; Cor. 1, 2/15/02; and Sup. 1, 2/6/02); and Selected Issues and Statistical Appendix (SM/02/35, 2/6/02)

Staff: Wakeman-Linn, EU2; Ebrill, PDR; Hemus, TRE

Length: 1 hour, 50 minutes

Mr. Cippà submitted the following statement:

My authorities would like to express their gratitude for the very constructive role the Fund staff has been playing in the formulation of macroeconomic policies in Azerbaijan over the last few years. For this review in particular, the good cooperation between the staff and the authorities has resulted in a comprehensive package of measures which will be instrumental in pushing forward the transition process of the Azeri economy. This is especially true in the energy sector, where the authorities have adopted a thorough reform program aimed at improving financial discipline. During the discussions about this reform program, the staff made clear what its objectives should be. At the same time, the staff kept an open mind as to how these objectives could be reached. This commendable approach allowed the authorities to come up with their own measures in order to reach these objectives. The result is an ambitious but realistic reform program with an exemplary degree of ownership.

Macroeconomic developments in 2001 were very positive with economic growth higher and inflation lower than projected. In terms of policy performance and program implementation, the authorities' record over the review period has been very encouraging. The waivers the authorities are requesting are due to relatively minor breaches of performance criteria which have been swiftly corrected.

Fiscal policy and Energy Sector

With regard to fiscal policy in 2001, the stance was more restrictive than programmed. The authorities reacted to a modest revenue shortfall by promptly reducing expenditure, avoiding accumulating arrears. For 2002, the authorities have taken a number of important decisions in the fiscal area. Most importantly, they have formulated a program to enhance the financial discipline in the energy sector which has the potential to positively affect Azerbaijan's economy in a major way. While it is true that the energy sector program was expected to be formulated by end-September 2001, the complexity of the undertaking was probably underestimated at the outset. In any case, the delay until January this year gave the authorities the necessary time to define, in close cooperation with the staffs of the Fund and the World Bank, measures which are both adequate and realistic.

The urgency of this program lies in the fact that a lot of resources in the energy sector are lost due to inefficiencies and wrong incentives. In order to show the magnitude of the problem to the Azeri people, the government has decided to publish the amount of the implicit state subsidy to the energy sector during the two last years, as well as the projected subsidy for this year. Starting in the first quarter of 2002, the quarterly reports on the consolidated government budget will contain the amount of the subsidy which is provided by the State Oil Company (SOCAR) to Azerenergy and Azerigas. In return, SOCAR will be granted tax credits in the same amount. From 2003 onward, the subsidies will be formally incorporated into the state budget. With these measures, the government intends to demonstrate to the public that the current subsidies to utility consumption are too heavy a burden for the state. Pointing to their opportunity cost, the government will then be in a reasonably strong position to implement the ambitious reform program to enhance financial discipline in the energy sector.

Beside the inclusion of subsidies in the budget reports and, eventually, the budget itself, the energy sector program contains a wide number of measures, detailed in the Letter of Intent. Overall, these measures are designed to generate higher payments by budgetary organizations, state-owned enterprises and households, to make utility producing and consuming companies more efficient, to speed up privatization in the energy sector, and to gradually unify domestic with world market energy prices.

Monetary and Exchange Rate Policies

Monetary policy has been sound in Azerbaijan for the last several years. Over the review period, monetary developments have been well in line with the program and all quantitative performance criteria for end-September 2001 were met. With respect to the exchange rate, the Azerbaijan National Bank (ANB) is intending to continue its policy of managed floating. The authorities are aware that, over the medium term, there is a need to consider the exchange rate policy in view of the expected increase both in oil fund expenditures as well as in oil sector revenues.

Structural Policy

As pointed out by the staff, the track record of structural reform in the last two years has been impressive. All measures subject to performance criteria have now been implemented and strong progress is continuing in a number of areas. In the banking sector, measures are being taken based on diagnostic studies of commercial banks done last year. In particular, five banks were closed, and both the minimum capital requirement and the limit on foreign ownership of domestic banks have been increased. The authorities are committed to eliminate the current limit of foreign ownership at the end of 2002. Furthermore, the new Banking System**s** Law will be submitted to parliament shortly. Regarding the technical violation of a performance criterion due to delays in the elimination of deposits in non-convertible currencies from the International Bank, it has to be noted that the amounts were very small and that the accounts were closed shortly after the deadline.

The authorities recognize the importance of advancing good governance. They therefore took a number of decisions such as strengthening the Chamber of Accounts, passing an improved procurement law, developing an anti-corruption law and accelerating the privatization process. In this respect, the non-observance of the performance criterion on adopting the revised law on the Chamber of Accounts was minor in our view. This law was submitted to parliament just a few weeks later than envisaged and contains all the crucial elements. Moreover, the draft 2002 budget includes adequate funds that will enable the Chamber of Accounts to implement its new responsibilities quickly. In the area of tax administration, it is important to note that the government has abolished the practice of negotiating tax payments for large state enterprises and that all taxpayers are now required to pay taxes based on their legal obligations.

Regarding the Customs Committee, the delay was due to factors beyond the authorities' control. Since the Azeri law requires at least three bidders for a tender to be valid, the tender had to be rerun in order to obtain enough bids. However, the evaluation has now been completed and based on it a Customs Committee reform program has been adopted in January. Crucial elements of this program include better data collection and control, revenue enhancement, trade facilitation, and greater accountability and efficiency of customs administration.

Technical Assistance Consultations

Technical assistance (technical assistance) provided by the Fund has generally been well received and successfully implemented. The authorities would like to express their gratitude for the professional and efficient technical assistanceAzerbaijan has been receiving from the Fund. They particularly appreciate the efforts of the resident advisors in the Treasury of the Ministry of Finance and the ANB as well as the technical long-term advisor for tax administration. Based on an assessment of their needs, the authorities believe that continuous technical assistancewill be most productive in the areas of fiscal and monetary policy capacity building. Furthermore, my authorities look forward to the mission scheduled for April which will assess

> the quality of macroeconomic statistics. Being mindful of the need of improvements in this area, they hope that the Fund would satisfy the request for a resident national accounts statistics advisor.
>
> My authorities recognize that some of the delays occurring in program implementation were due to a lack of a systematic monitoring of the overall reform efforts. They have therefore decided that representatives of the relevant government agencies will meet on a monthly basis to review the implementation progress under the program. Based on this meetings, monthly reports on program implementation will be prepared for consideration by the Prime Minister.
>
> To conclude, let me stress again that Azerbaijan has made significant economic progress during the review period. Despite some implementation delays, the program is on track and risks have been reduced. My authorities are grateful to the Fund for contributing to this success and look forward to continuing the fruitful cooperation.

The staff representative from the Treasurer’s Department (Mr. Hemus) recalled that paragraph 65 of the staff report, which referred to safeguards assessment, clarified that the policy approved by the Executive Board required that the safeguards assessment for a central bank be completed no later than by the first review under the member country’s arrangement with the Fund. In some cases, including for Azerbaijan, this deadline had been missed for technical reasons. The staff and management recognized the importance of the deadline for completing the safeguards assessment, and the potential implications of a missed deadline for a member’s Fund arrangement. When completion of a safeguards assessment was delayed beyond the first review, the staff could propose completion of the review—explicitly stated in the appraisal section—but the staff report should precisely indicate the reasons for making the recommendation, despite the delay in the safeguards assessment.

Azerbaijan was the first case for which the staff formally recommended completion of the review notwithstanding the formal noncompletion of the safeguards assessment, the staff representative continued. The reasons for recommending completion of the review were the limited risks of misuse and misreporting identified during the on-site assessment, and the authorities’ commitment to address the identified weaknesses. The safeguards policy was scheduled for review by the Executive Board in March 2002.

Ms. Vtyurina made the following statement:

> In 2001 Azerbaijan yet again delivered a rather impressive performance registering 9 percent growth, very low inflation, and a moderate external current account deficit. It is also not often when fiscal policy ends up being tighter than projected and a primary surplus is achieved rather than a projected deficit. While some of the targets under the program were completed with delays, we would like to congratulate the authorities for

completing all the requirements under the program. This said, allow me to make a few rather focused points:

Fiscal area: Despite the achieved surplus, there was still some shortfall in revenue due to the abandonment of negotiated tax targets for large state enterprises. As in many other transition economies, this issue is a very prominent part of discussions. In the Azeri case, the abandonment of tax targets was a valid measure as taxes should not be negotiated and no incentives to underpay should be given. I wonder, however, if the staff expects an increase in revenue collection any time soon because of this measure. The question here is whether the authorities possess enough administrative capability to determine state enterprises' capacity to pay, as was done in the case of SOCAR. In any event, abandonment of tax targets alone will not do much good unless strong efforts are taken to improve tax administration and compliance.

On the issue of VAT, I can partly share the authorities' view that its reduction could generate additional revenue. It is widely accepted that eventually in transition economies taxes should be lowered and their base widened. In this regard, I also welcome the recent efforts to streamline payroll taxes. At the same time, however, I can share the staff's apprehension that a reduction by about two thirds of a VAT threshold is excessive and I would appreciate if the staff could provide some information on the VAT level. I would also argue that if tax administration capacity and collection remain weak, such a decrease will only give the advantage of lower taxes to enterprises rather that substantially increase revenues for the state.

Overall though, I believe the jury is still out on the implementation of tax reforms in transition economies, since, as the staff themselves point out, data constraints limit the authorities' ability to estimate the impact of tax policy changes on revenue. Therefore, either side may have a valid point.

Expenditure wise, the priorities set out in paragraph 32 of the staff report are very appropriate, especially when it comes to goals to increase social expenditure and decrease non-payments for energy. On the latter, we very much welcome the intention to incorporate into the budget the previously implicit subsidies. If this is actually going to happen, it will create a very positive precedent for other countries. In the same vein, the discussion in the Selected Issues paper on the extent of the provision of implicit subsidies is very appropriate as due attention needs to be paid to this phenomenon. It would be useful if such analyses were conducted for every transition or any other economy, which is forced to subsidize energy consumption. This would help the authorities to get a better perspective on the severity of the situation, improve transparency, send strong signals to parties involved in the budget process as well as make the population aware of the magnitude of the problem.

This said, we do not share the Azeri authorities' argument that this process would create moral hazard. It would only do so if the authorities do not supplement this policy with a strong message that not only all budgetary entities are expected to pay but that all of the consumers are obliged to do so as well. This message needs to be a clear part of the overall program to enhance financial discipline in the energy sector and improve the state's fiscal position.

Of course, the origin of this problem comes from the high difference in world market and domestic prices for energy products, which costs the Azeri budget about 25 percent of GDP. Despite the gravity of this number, the situation is difficult to resolve without enduring social consequences. Therefore, we completely agree with the staff and the authorities that the unification of prices could only be completed in years, if not decades. The development of the timeline for the unification is certainly an important step, however, it would not mean much unless serious reforms take place in all areas related to energy consumption as stipulated in paragraph 50 of the staff report.

Oil fund: As is the previous issue, this one is also a "hot" topic in oil-producing countries. Although the asset management and budgetary rules for the oil fund have been set, there are already concerns that its assets would be invested in activities that undermine its original purpose of enhancing the development of the non-energy sectors of the economy. While the discussions on developing of a medium-term strategy and formally integrating the state and oil fund budgets will continue in the future, I wonder if there are adequate safeguards in place to ensure that no expenditures or investments take place before MTEF and PIP are produced. Also, I would ask the staff to shed some light on the interim investment strategy (instruments-wise) for the fund's almost $0.5 billion in assets.

Monetary area and banking sector: While inflation and exchange rate developments do not raise any concerns, as it seems that ANB is managing its monetary policy quite responsibly, the dollarization issue and the ANB's attitude towards it definitely attracted my attention. I can understand the authorities' and the staff's bewilderment about the continuing dollarization despite the evident macroeconomic stability. Growing oil sector certainly is one explanation. In my view, however, as in many other transition economies, the population still has not acquired enough reassurance that the manat is a strong enough and worthy currency. Its real depreciation, even slight, does not add to improving confidence since the population may not fully understand the reasons for such depreciation and exaggerate its significance. In this regard, the authorities' attempts to forcefully decrease dollarization will be counter-productive. While ordering transaction only in manats seems appropriate (although, I was surprised that these were allowed in dollars before), like the staff, we would very strongly recommend against the introduction of restrictions on the importation of foreign currency. For so many reasons this would be a wrong policy choice. I have raised a similar issue of rising dollarization at the discussion on Cambodia recently, contemplating the high dollarization of economy given the relative macro stability. In that case I completely agreed with the staff's views that trust in local currency would only increase if the structural reform process and right macroeconomic policies continued to be vigorously pursued.

On a more positive note, it seems like the banking sector is doing relatively well and being trusted as deposits are growing, especially in foreign currency. Accordingly, we welcome the developments and progress in the banking sector reforms, and, especially, the authorities' decision to increase the ceiling on the foreign share of banking sector capital to 50 percent, and we look forward to its complete elimination. This said, I saw very little information in the paper on the level of interest rates and credit environment. For example, how did a decreased public sector borrowing affect interest rate levels, and does the staff consider this year's projected credit growth at slightly above the nominal GDP as adequate, excessive or not? In regard to the former, I note from external sources that Agrocredit Bank, for example, provides loans at rates between 12 percent and 18 percent, which seem high given very low inflation and budget deficit financed from external sources, privatization and only modest domestic borrowing.

Finally, I noted that Azerbaijan incurred a violation of the continuous performance criterion on the stock of external arrears. While most of the amount was repaid in cash, $520,000 was repaid in kind while the creditor has not given his consent to the transaction. Nonetheless, this transaction is being treated as amount in dispute for program purposes and not considered arrears. In the recent case of Tajikistan the authorities were also disputing the legitimacy of the contract under the government guarantee; such action, however, was not acceptable to the Fund. I would like the staff to elaborate on the difference in treatment of the two cases of arrears as it relates to the concept of equality of treatment of members.

We support the review and wish the authorities well.

Mr. Baukol made the following statement:

At the outset I would like to commend the staff for putting together a strong set of papers for the discussion today, and to commend the authorities for their publication. In particular, the selected issues paper provides crucial new data and analysis on quasi-fiscal subsidies in the energy sector. We also appreciate that the staff paper addresses the issue of money laundering and terrorist financing. And, the staff paper includes a useful appendix that describes in detail the results of IMF technical assistance. With technical assistance taking up a large portion of the IMF's budget, such information is essential to judge the value of this effort. Such an appendix was also provided in our recent discussion on Kazakhstan, and we encourage their inclusion in all Article IV discussion staff reports.

The Azeri authorities have taken important steps in the past year to place the economy on a sound, sustainable footing. We welcome the strong macro-performance, the progress on establishing a well-structured, transparent oil fund, the establishment of the Chamber of Accounts, the adoption of a Customs Committee reform program and efforts to improve the efficiency of the energy sector, including the extension of a private sector management contract for the country's largest electricity distribution company.

Our concerns with the program focus on the energy sector, the financial sector, governance, and fiscal issues.

Energy Issues

With the most recent estimate of implicit sector subsidies at 27 percent of GDP, it would be an understatement to say that energy sector reform is critical to the success of the IMF program. The authorities recognize that improving payments discipline is essential and are developing a comprehensive reform program. However, there is room for more aggressive action. We are disappointed by the authorities' decision to wait until 2003 before placing subsidies to Azerenergy and Azerigas on the budget. While we welcome the decision to allow budget entities to be cut off for nonpayment, it is unclear how the authorities will tackle nonpayment by others. We encourage further measures to raise prices to world levels, set clear collection targets and cut off nonpayers. In addition, putting SOCAR on a sound commercial footing is an essential component of energy sector reform. Restructuring SOCAR will help free up public sector resources and reduce pressure on the oil fund to compensate for SOCAR's inefficiency.

While progress on establishing the oil fund has been impressive, but the work is not yet done, particularly with respect to expenditure management. We commend Fund staff for highlighting the need for sound expenditure management in the context of a medium-term public investment strategy. The authorities should continue to utilize the expertise of the IMF and the World Bank to develop the strategy and ensure that oil fund expenditures are in line with it. To reflect the significance of the oil fund in this framework, the authorities may want to consider expanding the membership and strengthening the role of the oil fund's supervisory board, including representatives from civil society and the international investment community.

Financial Issues

On financial issues, Azerbaijan needs a banking sector that will support broad-based economic growth. The staff correctly points out that the privatization of the International Bank of Azerbaijan (IBA) is a crucial next step. The intention to privatize IBA was originally announced in 1999, but progress has been slow. We urge the authorities to avoid further delays. The program's conditionality on the privatization of IBA and United Universal Bank (UUB) does not indicate a timetable for privatization or the steps involved. Could the staff elaborate on these, as well as on what weaknesses will be addressed in the Banking System Law, listed as a structural benchmark?

On dollarization, we support the comments of Ms. Vtyurina.

On the safeguards assessment, we appreciate the clarification by the staff. However, the safeguards policy calls for the assessment to be completed by the start of the program, or, at least by the first review. We would not like to see many exceptions to this policy, and we would ask why this review was not delayed until early March when the assessment is expected to be completed?

Finally on financial issues, we recognize the authorities' efforts to combat money laundering and the financing of terrorism, as described in the staff report. We urge the authorities to take any additional steps needed to freeze terrorist assets without delay and fully implement the UN Security Council Resolutions and Conventions related to terrorism, as called for in the IMFC communiqué.

Governance

On governance, the authorities have made strides to improve governance by initiating reforms of the Chamber of Accounts and Customs Committee, passing an improved procurement law, and developing a single Treasury account. We commend the staff for making other governance reforms prior actions for this review, and we would support additional conditionality on the implementation of key measures in this area going forward.

Separately, we look forward to the completion of the authorities' National Program for Poverty Reduction, which will provide an important avenue for improvements in governance. To this end, we support the staff's recommendation that the authorities postpone the July 2002 completion date, if necessary, to ensure an effective participatory process and optimal development of the NPPR.

Fiscal Issues

Finally, on fiscal issues, we support the comments of Ms. Vtyurina on tax administration and negotiated tax payments. We understand that the 2002 budget assumes World Bank SAC II financing of roughly $30 million by end-March. We understand that the conditions for this disbursement are almost—but not quite—met. We encourage the authorities to take the steps necessary to ensure that this disbursement can go ahead. As in other cases of countries with PRGF arrangements, this situation points to the need to be conservative when programming such funds into the budget, including the identification of alternative revenue sources when possible to avoid unwarranted pressures for disbursement. There is only one sound way to ensure timely disbursements – for the authorities to implement the agreed policy reforms aggressively.

Ms. Phang made the following statement:

The progress achieved by the Azerbaijan Republic in complying with difficult structural performance criteria and structural benchmarks in the program can only be described as remarkable, not just good. In addition, they have also managed to achieve strong economic growth with low inflation and a stronger external position. All this reflects the Azeri authorities' strong commitment to the agreed program and we support the completion of the first review under the PRGF-supported program. We also support their request for waiver of performance criteria as they have in effect been cleared as explained in both the staff report and Mr. Cippà's statement.

Overall, we concur with the thrust of the staff's appraisal but we have the following comments:

First, we reiterate the concern that we raised at the Board meeting in June 2001, namely, the importance of Azerbaijan's economic diversification with the aim of achieving sustainable growth and reducing poverty. While the oil sector accounts for 90 percent of Azerbaijan's export earnings and 30 percent of its gross domestic output, it only employs less than 7 percent of its labor force, unlike agriculture which accounts for 19 percent of GDP but 41 percent of the labor force. The average monthly wage in the agriculture sector is only about $15, way below the official definition for poverty. The skewness in income distribution is reflected in the fact that the average monthly wage in the agriculture sector is less than 10 percent of the highest paid sector, namely, the banking and insurance sector and less than 14 percent of the oil sector. Hence, we would appreciate some information from the Fund or World Bank staff on what viable alternatives there are for Azerbaijan to pursue in the interests of economic diversification.

Turning to structural reforms as specified in the various structural performance criteria and benchmarks, we note that significant progress has been achieved and the staff are working with authorities to tackle the enormous amounts expended on quasi-fiscal subsidies in the energy sector. Given the significant amount involved and the moral hazard involved in current practices, we commend the staff for the astuteness that they have shown in persuading the authorities to agree to an ambitious reform program. However, drawing on one important lesson that we should have learnt from the experience of the Asian crisis, we underscore the importance of allowing the authorities more time to implement the reforms as the task is not an easy one and has to be tackled sensitively and in stages so as to avoid triggering social upheaval.

On the fiscal front, we commend the authorities' efforts to improve the budget administration, particularly to raise revenue and to broaden the tax base. We concur with the staff's views on the importance of enhancing fiscal discipline and the need for guidelines on the use of the oil fund and we encourage the Fund and World Bank to provide appropriate technical assistance for this purpose. However, we are not convinced by the staff's arguments against the budget proposals of the Azeri authorities which appear to have a good basis as they plan to increase disposable income through lowering the payroll tax, encourage consumption through lowering the VAT and divert some savings arising from their energy reforms to spend more on education and social services. Hence we would appreciate if the staff could provide an analysis of the net impact on the budget of the total package proposed by the authorities, perhaps under various probable scenarios, if necessary, as the bits and pieces of information on the cost saving or otherwise of some of the measures does not provide an adequate assessment of the feasibility of the proposed package.

Turning to banking sector reforms, we could not agree more with the staff on the need to create a competitive banking system. Toward that end, we agree that privatization that is properly sequenced and paced is a step in the right direction in terms of supporting a private sector driven growth strategy. However, experience has shown that countries usually need to develop domestic banks to support their developmental efforts. Hence, privatization need not necessarily be confined to selling the government's stake to foreign investors and the authorities may need to bide their time to select a fit and proper investor from among domestic investors.

Finally, in relation to the banking sector, we would appreciate the staff's views on the implication of the high level of dollarization on the role of the banking sector in supporting the development of a diverse economy considering that more than 70 percent of its loans are foreign currency loans. This implies that sectors which do not have earnings in dollars, namely, the non export-oriented ones, are not likely to be able to gain access to such loan facilities. Furthermore, the staff have stated that they are at a loss to explain the high rate of dollarization. The answer probably lies in the fact that customers are encouraged to have dollar deposit accounts since the rate of depreciation of the manat at about 5 percent is higher than the interest differential of 1.1 percent while banks are encouraged to lend in foreign currency rather than domestic currency as the interest charges are 2 percent higher. The staff's views are welcome.

With these comments, we wish the authorities continued success in their management of the economy.

Mr. Harzer made the following statement:

Let me first thank the staff for the comprehensive and well-focused report, as well as Mr. Cippà for his informative statement. We broadly concur with the staff's assessment of Azerbaijan's economic performance, and support the proposed decisions.

As pointed out by the staff, there are only limited risks of misuse of Fund resources and misreporting. Therefore, it is acceptable to complete the review of the PRGF-supported program although the final report on the safeguards assessments has not yet been concluded. However, we urge the Azeri authorities to have this report completed by the next review of the PRGF-supported program, at the latest. Furthermore, granting the requested waivers is appropriate, notwithstanding the repeated delays in the structural area. Concerning the existence of external arrears toward Uzbekistan, we urge the Azeri authorities to seek a quick solution.

The Azeri authorities are to be commended for the overall impressive macroeconomic and structural track record in 2001. The fact that the growth in 2001 was experienced throughout the whole economy is particularly noteworthy, given Azerbaijan's heavy reliance on the energy sector. On the structural front, measures such as increasing the ceiling on the share of foreign banks, the termination of negotiated tax payments for large state enterprises, and—probably most importantly—the adoption of a comprehensive energy sector plan demonstrate the continued reform commitment of, and the high degree of ownership by, the Azeri authorities.

However, as mentioned in the staff report, considerable risks still remain, especially in the medium- to long-term outlook. Against this background, I have five additional remarks. First, the staff's short- to medium-term balance of payments projections seem to be on the optimistic side. While declining oil prices will certainly increase the current account deficit, we are less optimistic than the staff regarding the possibilities for compensating a deficit widening with an improvement in the capital account. FDI inflows may turn out to be lower than projected given low oil prices, as well as the risks related to the full development of the three major investment projects in the energy sector.

Second, we are somewhat concerned about the projected sharp increase in the current account deficit in the next two years. This rise remains significant even when disregarding the increasing import levels needed for major investment projects in the energy sector. We wonder whether such a program design is compatible with one of the PRGF's main aims, namely to strengthen the balance of payments situation of program countries.

Third, we support the staff's recommendation to develop guidelines in 2002 for the legitimate use of the oil fund. Furthermore, we agree with the staff that the oil funds should primarily support efforts to further diversify the economy, thereby reducing its external vulnerability. In contrast, using the proceeds of the oil fund in order to finance the government's share in the Baku-Tbilisi-Ceyhan (BTC) pipeline project would certainly not fit into a diversification strategy.

Fourth, restructuring the energy sector is key to enhancing the overall efficiency of Azerbaijan's economy. It is therefore somewhat disappointing that the authorities did not manage to disclose energy-related hidden subsidies already in the 2002 budget. Consequently, the alternative envisaged—quarterly publication of quasi-fiscal subsidies—must be thoroughly executed. Enhanced transparency in the energy sector constitutes a major precondition for its successful restructuring.

Fifth, regarding the development of PRSPs, this chair has repeatedly voiced the general view that quality should prevail over speed. Therefore, we could accept some delays in the completion of the full PRSP if this would ensure that the shortcomings of the interim PRSP, especially concerning the effective participatory process, are appropriately addressed.

Finally, we are pleased to learn that the Azeri authorities stand ready to continue their ROSC exercise. With these remarks, we wish them all the best for their endeavors.

Mr. Maciá made the following statement:

Azerbaijan's broad-based economic growth remained strong during 2001, notwithstanding the international economic slowdown and the oil price declines. Restraint in foreign-financed capital expenditures and in public wages helped to achieve a consolidated government surplus in face of diminishing tax revenues, and a drop in privatization receipts. The fiscal constraint efforts also helped to subdue inflation further. At end-September 2001, all quantitative performance criteria and structural performance criteria (Box 1) were accounted for. The exchange rate remains market-determined, and we concur that the existing policy of intervention only to offset temporary exchange pressures should continue as is. The external current account deficit has remained fairly stable for 2001. For 2002 and the medium term, much larger deficits are envisioned in the current account as the gas and pipelines projects are developed. FDIs, multilateral and bilateral assistance, and possibly higher oil prices are expected to compensate for the financing gaps.

Structural reforms have progressed well. We welcome the strengthening of the Azerbaijan National Bank's internal operations and supervision efforts, the enforcing of prudential standards, and the improvements in the payments system. The privatization of International Bank and of United Universal Bank should be dealt with expeditiously, as well as the elimination of the limits on foreign ownership programmed for the end of the year. The 2000 ROSC recommendations encouraged steps to streamline the budget process, reinforce the Treasury function, merge the employment and social fund with further Treasury control, and create the public investment program (PIP) to be operational in 2003. The strengthening of the Chambers of Account, the new procurement law, and the anti-corruption law presently in Congress should endeavor "the advancement of good governance" as clearly stated by Mr. Cippà's statement. We praise these actions.

The envisioned 2002 economic growth rate should be, with no doubt, achievable. The overall government deficit should remain minor as noted in the staff report. Revenue projections will be affected by the scale down effect in the payroll tax, VAT threshold, and the income tax. We praise the elimination of the double counting of investment deductions, the move of SOCAR to pay larger taxes, and the decision for public organizations to pay for their utilities. We welcome the cap on budgetary organizations' utility bills and the increase in social sector expenditures.

A major challenge remains in the implementation of all actions to attain financial discipline in the oil sector. We await the progress and effects of the tax credit to SOCAR to cover energy subsidies extended to utilities, and the controls through on-site monitors. We praise the explicit subsidies for the most needy in society. The signing of management contracts for electricity distribution is an important initiative to enhance competition within the sector, while its crucial to move forward with a timetable for the unification of domestic and world market prices for energy products, as well as for further privatizations in the sector.

We concur with the waivers on one continuous and three structural performance criteria, and agree with the staff request for completion of the first review under the PRGF arrangement. This chair commends the authorities for their perseverance and dedication.

Mr. Sazanov made the following statement:

In recent years, including 2001, Azerbaijan has made steady economic and financial progress, except for some minor delays in structural reforms.

Azerbaijan's overall performance, which produced higher than programmed growth, low inflation, and a higher than projected consolidated government surplus, justify us in completing the first review under the PRGF and granting the requested waivers of three structural performance criteria for the end of September 2001 and the continuous performance criterion on the stock of external arrears. All these delays were temporary and had no strong effect on Azerbaijan's overall performance, and the authorities' strong determination to address the structural reforms remains as strong as ever.

Since we broadly agree with the staff appraisal, we will limit our remarks to some major points that need immediate attention.

Azerbaijan's economic growth remains overdependent on oil and oil-related exports, which is a factor in the widening of the current account deficit following the drop in oil prices and makes Azerbaijan's overall economic performance more vulnerable. We therefore applaud the government's comprehensive program to reform the energy sector, which despite some departures from the original schedule, still appears realistic.

The authorities must continue their efforts to diversify the production base by developing the agriculture sector. This will simultaneously reduce the economy's vulnerability to external factors and help alleviate poverty.

We also urge the authorities to continue improving the climate for investments, especially in the energy sector, to strengthen Azerbaijan's balance of payments and growth prospects. The measures designed by the authorities and described in the letter of intent for enhancing payment discipline, accelerating privatization, and unifying domestic and world prices are most significant.

Financial reform have proceeded vigorously for the last two years. The strengthening of banking supervision, the liberalization of the rules on foreign ownership of banks, and the anticipated Banking Systems Law will improve the efficiency of the financial system and contribute to higher economic growth. The progress of tax administration reforms is promising, and we applaud the authorities' intention to impose the VAT on the destination basis to increase revenue. We join the staff in urging the authorities to undo the tax "reform" which reduced the VAT threshold.

We also share the staff's concern about the regulation of expenditures from the oil fund, and urge the authorities to move quickly to protect their medium-term plans for economic development.

We support the proposed decision and wish success to the authorities in their future endeavors.

Mr. Monajemi made the following statement:

We would like to thank the staff for the well-written report and Mr. Cippà for his informative statement. The Azerbaijan economy continued to make good progress on several fronts despite the shocks to the domestic economy and the reduction in oil prices. Real GDP growth exceeded the already high program target, and financial policies were tighter than programmed. Inflation declined. The external account deficit remained unchanged from 2000, despite an almost doubling of oil-related imports, and international reserves increased further than anticipated. The consolidated government's fiscal position turned into surplus, with expenditure being brought under control following a shortfall in several financing items.

On the fiscal front, the authorities continued progress in tax administration is laudable. We welcome the move in requiring all taxpayers to pay taxes based on legal liabilities, but we would appreciate the staff's elaboration on the reduction in the VAT threshold. On the expenditure side, the problem of quasi-fiscal subsidies remains a matter of concern. And the SOCAR subsidies to Azenergy and Azerigaz should be incorporated into the budget, as soon as possible.

We note with satisfaction the authorities' commitment in the interim PRSP to increase expenditures on education, health, and social protection.

As for the oil fund, we urge the authorities to produce the necessary documents so that its expenditures are integrated in due time in a government approved medium-term expenditure framework.

We concur with the thrust of the authorities' monetary policy, we welcome the ANB's decision to target a low level of inflation of 3 percent for 2002, as well as the limited-intervention policy in the foreign exchange market to offset temporary exchange rate pressures.

We commend the authorities' substantial progress in structural reforms. We encourage them to give high priority to the preparation and execution of a consolidated fiscal position. While we commend the reforms in the banking sector, we urge the authorities to press ahead with the full privatization of International Bank, and to strengthen the regulatory framework and the enforcement of prudential requirements on United Universal Bank.

We welcome the authorities' commitment to reduce the number of import tariffs, as well as their efforts to accelerate the process of accession to the WTO. We urge the authorities to intensify their efforts in diversifying Azerbaijan's production base to reduce vulnerability. A stronger private sector involvement, including through privatization, will be key to diversification and enhanced efficiency. The authorities have taken commendable steps to improve governance, such as the expansion of the authority of the Chamber of Accounts, the passage of an improved procurement bill, and the development of an anticorruption law. We note with satisfaction the authorities' measures to eliminate funding sources for international crime and to prevent money laundering.

With these remarks, we support the proposed decision and wish the authorities every success in their efforts to enhance growth performance and reduce poverty.

Mr. Padoan made the following statement:

First of all let me thank the staff for the interesting report and the selected issues paper, as well as Mr. Cippà for his informative statement. I also add that I support the proposed decisions.

The authorities are to be congratulated for a highly satisfactory performance. The macroeconomic data confirm that Azerbaijan is set on a path of stability and growth. The challenge ahead is, of course, to consolidate the results and to maximize the benefits of the country's resources for advancing in the fight against poverty.

This is not an easy task and it requires strong ownership. However, the record so far demonstrates, as Mr. Cippà notes in his statement, that the authorities are quite capable of addressing the situation and show a high degree of ownership.

The oil sector is at the center of a major transformation underway in the economy. At the end of the process, the utilization of natural resources will be much more efficient than it is today and the fight against poverty will be much more successful.

Today, as the Selected Issues paper demonstrates, we are still far from such a goal. Twenty-seven percent of GDP is an amount of subsidization that cannot be sustained. Even less so as the economy fully opens up to international markets. The first step for progress in the right direction is transparency. In this respect, I agree with the staff that the amount of subsidies should appear clearly in the budget so as to openly present the state of things to the country and to call on the parties involved to assume responsibility. I welcome Mr. Cippà's clarifications in this respect. The second step is to redirect the structure of the budget and of public expenditure towards the fulfillment of basic needs, such as health and education. The rate of growth of expenditure for these two items cannot be considered as fully satisfactory.

An additional element of the strategy must be the diversification of the production base. A more efficient exploitation of natural resources is certainly desirable but it does not represent the only possible strategy as the integration in the world economy proceeds. So far the degree of diversification has been quite modest, as figures in Table 7 and in the annex suggest.

I have a few questions for the staff related to the last point. One is on exchange rate policy, which the staff report defines as appropriate. Figure 2 in the staff report shows a steady decline in the real and nominal exchange rate. Does the staff consider such the evolution appropriate or the current level of the exchange rate appropriate? Are both the evolution and the level of the exchange rate appropriate as incentives for increasing the allocation of non oil resources in the tradable sector?

A second question relates to the fact that future trade deficits should be financed by substantial FDI inflows related to the oil sector. To what extent are such FDI flow projections sensitive to the evolution of the price of oil?

Finally, dollarization, the extension of which is relevant. Further dollarization would substantially change the medium-term perspectives, and possibly the options the country faces. Does the staff expect dollarization to continue in the future? Is the ongoing depreciation of the currency a further incentive towards dollarization? What is the authorities' view in this respect?

Responding to questions raised by Directors in the fiscal the area, the staff representative from the European II Department (Mr. Wakeman-Linn) said that the initial impact on revenues from the elimination of tax targets had been negative, even though the policy reform had been appropriate. The way the tax targets had been negotiated had resulted in some state enterprises paying less than their legal tax liabilities, while others paid more than their statutory tax obligations. With the elimination of the tax targets, the state enterprises that had previously paid more than their legal tax liabilities had quickly adjusted their payments. However, those that had previously paid less than their legal tax obligations had taken time to adjust their payments. The authorities were taking a number of measures in 2002 to improve collections from the second set of state enterprises.

The current VAT level in Azerbaijan was 18 percent, the average rate for transition countries, the staff representative continued. The authorities had expressed their intention to gradually reduce that rate over time. The staff would not oppose such a move if it formed part of a comprehensive and sensible fiscal policy.

Regarding the package of revenue measures that the authorities had proposed, the staff had encouraged the authorities to move gradually on those reforms partly because the database had not been adequate for accurately assessing the impact of the reforms, the staff representative explained. The staff would continue to work with the authorities to strengthen their database and their ability to assess the impact of tax policy changes over time.

With regard to the oil fund, there was currently no clear investment or expenditure strategy in place, nor was there a medium-term expenditure framework or public investment program in place, beyond the authorities' intention to use the oil fund assets for pressing social needs and to help address the development of the non-oil sector. In 2002, expenditures from the oil fund would be limited to approximately $35 million and used to help improve the living conditions of refugees and internally displaced persons, improve housing facilities, and expand agricultural development. In 2002, the authorities intended to develop a comprehensive MTEF and PIP in close cooperation with Fund and Bank staff. The authorities had adopted a rather conservative investment strategy—perhaps more conservative than ideal but probably appropriate for the short run. Currently, investments by the oil fund were limited to deposits in highly rated international banks, and some purchases of highly rated government papers. Over time, as portfolio managers began to manage a portion of the fund, they would have greater flexibility in the choice of investment vehicles, including equities. All investments, however, must be highly rated, a requirement that essentially precluded investing in domestic assets.

On energy sector reforms, it was important to distinguish privatization from deregulation, the staff representative remarked. The California case was one of deregulation, not privatization. There was no intention to deregulate the energy industry in Azerbaijan in the foreseeable future, but there was an intention to privatize the utility and energy distribution companies to improve efficiency and collections. Privatization, however, was only one part of a comprehensive reform package. The World Bank was advising the authorities on the proper timing of the planned privatizations.

The new banking system law would improve the ability of the central bank to handle problem banks and control the issuance of licenses to banks, the staff representative explained. The law would strengthen the central bank's enforcement capacity for dealing with troubled and insolvent banks. The authorities were working very closely with Fund and Bank staff to design the law, which was the reason why it had not yet been submitted to parliament. It had taken some time for a consensus to emerge among the different groups that had been advising the government on the matter.

On the issue of dollarization in Azerbaijan, it was possible that the interest rate differential between dollar and manat assets had been contributing to the problem, the staff representative considered. However, that raised the question of why the spread between dollar and manat assets was very low, given that the Azeri authorities did not influence interest rates.

On domestic credit, the rate of growth for 2002 was adequate, the staff representative continued. The issue, however, was the limited supply of potential customers that banks would be willing to lend to, primarily because very few enterprises in Azerbaijan had adopted international accounting standards, which made it difficult for banks to assess the financial position of companies. There were also difficulties related to the use of collateral and bankruptcy provisions. The authorities would work on those issues in 2002, in consultation with Bank staff.

Concerning the non-oil sector, the World Bank was taking the lead in designing programs to develop the sector in Azerbaijan, the staff representative said. Agriculture and agricultural processing appeared to have the greatest potential for further development—at least in the short to medium run. Fund and Bank staff and the authorities considered that it was important not to pick winners, but to identify sectors that could be competitive, and encourage their development by improving the business environment and governance, pursuing structural reforms, and developing infrastructure.

On the impact of oil price changes on foreign investment, the staff representative explained that foreign investors had targeted their investments to yield a desirable rate of return at a price of $16 a barrel and an acceptable rate of return at a price of $10 a barrel. Hence, even if prices fell to $10–14 a barrel, the planned investments would still go forward. Investors viewed those investments as long-term projects not likely to be seriously affected by short-term fluctuations in oil prices.

On the issue of arrears, the disputed case with Uzbekistan was different from the case of Tajikistan, the staff representative considered. The original contract between the Azeri and Uzbek parties allowed for the Azeri debt to be paid with goods delivered by the Azeri company to Uzbekistan. The question was whether the party who signed the contract on behalf of Uzbekistan had the right to make such a commitment. Hence, in the staff's view, the case was a matter of a disputed debt rather than a case of arrears.

On the exchange rate, the staff viewed market-determined exchange rates to be appropriate under the current environment, the staff representative stated. The central bank did not target a specific rate of depreciation. Its net intervention each year over the past two years had been roughly zero, with purchases and sales at various times to smooth fluctuations, but not to resist the trend. Moreover, there was currently no evidence of a Dutch disease problem in Azerbaijan, which would indicate that the exchange rate had over appreciated. The authorities would have to watch exchange rate developments closely, particularly in 2005 and beyond when oil revenues increased dramatically.

The staff representative from the Policy Development and Review Department (Mr. Ebrill) said that, with respect to the VAT threshold, the issue had been a point of contention between the authorities and the several technical assistance missions that had gone to Azerbaijan. Most countries tended to opt for very low thresholds, based on the idea that most taxpayers should be captured in the VAT net. However, administrative costs significantly increased as the threshold was brought down, and the revenue gain ended up being quite modest. Hence, the VAT threshold should be reasonably high. To elaborate, for the case of small retailers, if the VAT worked successfully, taxes would be collected at the different stages of production up to the final stage. The only revenues at risk then would be the small-retailers' margins, which were very small amounts. In contrast, it would not be possible to exempt small retailers with a retail sales tax because all the revenue would then be lost at the final stage.

A reasonable threshold, based on staff simulations, was about $50,000, the staff representative continued. The threshold amount actually recommended in each case would depend on the value added and the sector, although discriminating across sectors would complicate the system. In the case of Azerbaijan, the staff's rough estimate indicated that the threshold currently was substantially less than $10,000.

The staff representative from the Treasurer's Department (Mr. Hemus) said that, in general, the staff could not accurately predict dates for the completion of safeguards assessments. The staff had conducted the on-site assessment for Azerbaijan in early January, and the authorities had committed to putting in place remedies for the vulnerabilities that had been identified, which had not been as significant as had been anticipated in the Stage I report. The staff had, therefore, expected that the report would be completed by the time of the current Board meeting. However, the external auditors still had to give their confirmation, and the authorities their formal response to the report. Nonetheless, given the relatively minor risks of misreporting and misuse of Fund resources, as well as the commitment by the authorities to implement the remedies, the staff had not considered it necessary to delay the current Board meeting.

Mr. Al-Azzaz made the following statement:

> I am encouraged by Azerbaijan's continued commitment to the PRGF-supported adjustment and reform effort. The program remains on track. The economy has also been responsive with performance on both growth and inflation fronts better than projected. I therefore support the proposed decision to complete the present review and grant of waivers of performance criteria.
>
> Looking forward, the authorities' ambitious program, if fully implemented, would provide the appropriate framework to consolidate and extend the progress already achieved.
>
> In view of the comments made by previous speakers and the staff, I can be brief.
>
> The authorities deserve credit for the significant improvements in the fiscal area. However, it remains uncertain whether the projections for revenues envisaged in the program would be achieved. Here, I note especially the staff's view that the reduction in the VAT threshold will not generate additional revenue and the limitation on estimating the impact of tax policy changes on revenue projections. Therefore, I encourage the authorities to monitor the revenue situation closely and to move cautiously in considering additional tax reduction.
>
> On the expenditure side, I note the authorities efforts to enhance the financial discipline in the energy sector. The emphasis on streamlining the budget system and strengthening expenditure controls will not only enhance efficiency but also facilitate the avoidance of budgetary arrears in the future.

On the banking sector, I welcome the progress made in rehabilitating United Universal Bank and the ongoing effort to complete full privatization of the International Bank. I am also encouraged by the continued efforts to strengthen bank supervision and enhance operations of the payments system. The focus on improving competition should further strengthen efficiency and confidence. The authorities' intention to develop an action plan to address factors inhibiting competition is important in that regard.

I agree that administrative measures to reduce dollarization should be avoided. In this connection, I look forward to the staff's proposed study of countries' experiences regarding attempts to reverse dollarization. Indeed, such a study would be of considerable general interest.

With these remarks, I wish the authorities further success.

Ms. Phang agreed that, in efforts to diversify the economy, the authorities should not pick winners. She wondered, however, whether the staff had a general sense of those sectors where the Azeri economy had comparative advantage. On privatization, given the current difficulty in attracting foreign investment, the question of timing and sequencing was relevant. She wondered whether the authorities were ready to proceed with the privatization process, or whether they had just started to consider the idea of privatizing public enterprises.

Mr. Cippà said that the central bank had been very concerned about the dollarization of the Azeri economy, but that it did not have a defined strategy to deal with this issue. The central bank had considered some measures, including requiring payments in manat and restricting imports of foreign currency, which was a controversial move. The central bank was aware that the staff did not support the latter measure, as it could give rise to two exchange rates. The authorities looked forward to the review being prepared by the staff.

Mr. Radev made the following statement:

Let me commend the staff for the well-prepared report and the authorities for the continued strong economic performance. I will focus on two interrelated issues: fiscal consolidation and financial discipline in the energy sector. At first glance, the fiscal position looks strong. At the same time, the lack of real consolidation, the substantial level of arrears, and implicit subsidies in the energy sector increase uncertainties in estimating both the current situation and future prospects. As Mr. Baukol and Mr. Harzer said, this problem can be addressed more aggressively by the authorities. I concur with Mr. Padoan and strongly support the staff position that the government should explicitly incorporate the subsidies from the state oil company into the budget, and the company should pay its full tax liability. The scheme is a compromise that raises at least three questions: the transparency of the operations, the capacity of the authorities to implement the so-called noncash scheme, and the risk of further exacerbating the problem instead of addressing it adequately. A more decisive and transparent approach to the full and explicit incorporation of those activities into the budget, as the experience of other countries show, would give a better result. This would have to be implemented not only for the immediate purposes of the program, but should be underpinned by the appropriate legal institutional changes to ensure medium- and long-term sustainability of consolidation.

As the staff noted, the main source of financing for the general government deficit would be external financing. This is another uncertainty for the program, which could have a significant impact on the external position and growth prospects. It could also undermine the fiscal position. The authorities should be urged to incorporate buffers in the fiscal program in case of delays in foreign financing. The improvement in management and evaluation of capital spending projects in 2002, especially in the context of the significant increase in capital expenditures financed by the oil fund, is also a key issue.

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

Mr. Jin made the following statement:

I would like to thank the staff for their report on Azerbaijan's economy, especially the in-depth analysis on the very important energy sector of this country. I also thank Mr. Cippà for his informative statement. It is obvious that the Azeri economy has achieved an impressive rapid growth. With close consultation between the authorities and the Fund, the macroeconomic policy has been generally appropriate to attain a favorable economic environment. Since I am in broad agreement with the staff appraisal, I will just make a few comments for emphasis.

On fiscal policy, I share the view that the dominant issue to be resolved is financial discipline in the energy sector. Given the relative importance of this sector in the economy, it is vital to enhance payment discipline, improve the efficiency of the utility companies, modernize corporate governance of both the energy supplier and consumer, and gradually unify domestic oil prices with prevailing world market levels. I am encouraged that the authorities have recently adopted comprehensive reform program.

On monetary and financial policy, I agree that money supply has been appropriate in supporting economic expansion while keeping inflation under control. The exchange rate policy also seems flexible and therefore sustainable, given the relatively small size of the Azeri economy. There remains some concerns, however.

The first concern is that the projected current account deficit for the years up to 2005 is very high. Much of the deficit is associated with oil sector imports induced by large foreign capital investment. Since the uncertainty of these foreign capital inflows remains very high, the authorities may want to prepare different policy packages to deal with this uncertainty.

The second concern relates to banking sector reform. I appreciate the efforts made by the authorities and the Fund to identify the factors that may impede competition in this sector. Nevertheless, given the monopolistic market structure in the banking sector, it may be helpful to ease the entry policy to allow more institutions to compete. Privatization and raising the limit of foreign ownership alone may not truly solve the existing problem of lack of competition.

Third, I share the concern of the authorities on the trend of dollarization. I am pleased that the staff will review the experiences of other countries that have combated dollarization and hope an appropriate policy response can be worked out.

On the first review under the PRGF arrangement, I agree with the staff's recommendation and support the authorities' request for waivers of one continuous and three structural performance criteria, since all the policies subject to performance criteria have been implemented and the delays did not jeopardize achievement of the programs' objectives.

With these remarks, we support the proposed decision and wish the authorities continued success in their economic management.

Ms. Saito made the following statement:

I congratulate the Azeri authorities for sustaining macroeconomic stability as well as for making progress on some important structural fronts. I broadly concur with staff's appraisal and support the proposed decision. I would now like to make a few points on structural reform, for emphasis.

State Oil Fund

On the oil fund, I am somewhat alarmed about the debate to use these funds to finance pipeline developments. The initial intention of the fund was to assist in the development of the non-oil sector and to diversify the economy to make it is less vulnerable to fluctuations in oil prices. I would therefore encourage the authorities to produce a Medium Term Expenditure Framework and the Public Investment Program soon, so that there is a firm guideline for appropriate use of the funds. I have one question: am I correct in understanding that during the time of compiling the MTEF and PIP, no expenditures besides operating expenses will be made from the fund?

Energy Sector

I appreciate staff's analysis in the Selected Issues paper on the size of the quasi-fiscal subsidies in the energy sector. It is encouraging to see that, although with some delay, a comprehensive reform program aimed at strengthening financial discipline in the energy sector was formulated, and that the authorities were able to identify aspects to be included in the program. While measures such as establishing consumption ceilings would directly contribute to limiting the inefficient overuse of resources, I also hope that identifying the subsidy amounts in the budget will spark parliament's interest in the need for reform on the problems (such as pricing) in this sector. It will also be important to complement these with continued efforts in payments collection.

Financial Sector

Banking sector reforms are crucial in supporting the development of the non-oil sector, which cannot rely on FDI for its financing. As foreign banks could play a role in increasing lending to the non-oil sector, I welcome how the limit on foreign ownership of banks has been raised, and that such limits will be eliminated eventually.

Finally, I share some of the sentiments raised by Ms. Phang and Mr. Padoan concerning the importance of the diversification of the economy and the development of the non-oil sector. Although I take note of the staff's explanation and how the authorities feel that not to identify winners and that improving the general investment environment, including governance, is important, given that economic diversification is the main pillar in poverty reduction strategy, plus the fact that this is an Article IV, perhaps some more could have been reported.

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

Mr. Le Gal made the following statement:

Economic performance in Azerbaijan was satisfactory in 2001 with high growth, low inflation, and fiscal over performance. We commend the authorities for such an achievement and we encourage them to pursue on this path. The program's targets have been reached and although the structural performance criteria were met with delay they have been implemented before the review. We therefore approve the completion of the review and the proposed decision.

Having said that, I would like to comment on two sets of issues:

The first set of comments is to emphasize my support for the Staff's recommendations, particularly in the area of cross-subsidies in the energy sector and in strengthening the financial sector.

The second set of comments is to point out what, in my view, is missing in this Article IV report. There is little if any analysis of the non-oil sector or of the high level of dollarization and there is no reference to regional issues.

On the first set of issues, I agree with the Staff's appraisal and the analysis developed in the selected issue papers about the need to enhance financial discipline and to make the cross-subsidies transparent through their integration into the budget. It might take time to reduce these subsidies given their actual level, but the first steps are indeed to make them explicit. In the same vein, I support the Staff's proposal for the development of a medium-term economic framework and the integration of the oil fund into the government's overall strategy.

I also strongly support the recommendations in paragraph 64 and 67 on the continuation of the banking sector reform, the strengthening of banking supervision as well as the improving of governance. On these subjects, I would appreciate it if Staff could elaborate a little bit on the reason why the privatization of IBA has been delayed and if staff could update us on the progress in further improving governance in 2002.

To sum up, I fully support Staff's recommendation for further structural reforms aimed at increasing transparency, improving the business climate and enabling the government to run sound policies and attract more FDI. In spite of a low level of debt and high investment flows into the oil sector, Azerbaijan is benefiting from the support of IFIs at concessional terms. This generous support from the international community should be matched by a strong implementation of reforms.

On the second set of issues, I was a little frustrated by the absence of analysis on a couple of issues that should be addressed in an Article IV report.

First, it is difficult to figure out from the report what is the situation of the economy outside the oil-sector. I didn't see any discussion of the labor market, unemployment or the different sources of growth. The issue of economic diversification is certainly important and I think it should be addressed in the surveillance report. Also, a reference to unemployment would easily find its place in a PRGF report.

I agree that the Fund's role is not to pick up the "winners" but by its policy recommendations it can help to create the conditions for the development of the non-oil sector.

Second, the high level of dollarization that took place in spite of macroeconomic stabilization is puzzling. I note that Staff will prepare a “review of experiences of other countries that have combated dollarization” but an analysis of the underlying reasons in this country should be initiated and I am looking forward to this. In footnote 6, Staff suggests that this trend of increasing dollarization could be related to the growth of the oil sector. Hence, the need for an analysis of the dual nature of the economy and of developments in the non-oil sector.

Third, there is hardly any reference to the regional environment of Azerbaijan. It’s all the more regrettable that in a background paper on “Poverty Reduction, Growth and Debt sustainability in low income CIS countries” the importance of regional issues has been recognized. I think today’s surveillance report should have at least referred to this background paper that will be discussed tomorrow in a Seminar in London and in fact it could have elaborated in more details on issues specific to the Caucasus, like foregone trade, high transportation costs, etc.

I hope these issues will be addressed during the next Article IV consultation.

Mr. Joicey made the following statement:

We agree with what other Directors have said about the strong performance of the Azeri economy and the welcome progress of the authorities in structural reform, in addressing the recommendations of the 2000 ROSC, and in governance. We can support the completion of the first review and the request for waivers.

I want to pick up on Mr. Padoan’s point about the importance of having an overarching priority in taking forward the fight against poverty. This points to the importance of strong country ownership, close collaboration between the Fund and Bank—which appears to be happening based on today’s discussion—and cooperation between all donors. As Mr. Le Gal mentioned, these themes, as well as the regional factors, could have been addressed by referring to the background paper in the staff report.

I want to pick up on some areas that have already been discussed at length: the importance of diversification and tackling the barriers to growth in the non-oil sectors. The staff’s response regarding the importance of creating the right environment for business and taking forward structural reform, including further strengthening governance, was helpful. But again, I would agree with Mr. Le Gal and Ms. Saito on the importance of having a fuller discussion of the non-oil sector in the paper.

Secondly, we have discussed the importance of incorporating the oil fund into the overall medium-term strategy and budget, and the need for clearer guidelines on the use of oil fund assets, and the staff's comments were helpful.

On the PRSP, we certainly agree with the points in the staff report on the importance of broad participation, but hope that this aspect can be taken forward as quickly as possible, and the PRSP completed as close to schedule as possible. The PRSP will be key to making progress in the fight against poverty. When we discussed the interim PRSP last July 2001, the staff mentioned that there were potentially some problems in completing it because of lack of capacity. I wonder whether they still see that as a risk.

We welcome, like Mr. Baukol, the measures to combat money laundering and tackle the financing of terrorism. Three further quick points on the safeguards assessment. Again, I would agree with Mr. Baukol that the exceptions should be kept to a minimum. But the staff's comments were helpful in that respect.

Finally, we would want to commend the authorities for their decision to publish the paper, which reflects their strong performance.

Mr. Prasad made the following statement:

We thank the staff and Mr. Cippà for the report on the program performance. We generally agree with the staff's recommendations. The higher economic growth and low inflation are encouraging signs of the program performance. We note that all quantitative performance criteria were met. However, there are concerns about the slow implementation of some structural reforms and nonobservance of the continuous performance criterion on the stock of external arrears. We appreciate the discussion in this regard, and support the proposed decision.

We compliment the Azeri authorities for incorporating comprehensive measures, as called for by the staff. The fiscal policy measures to increase revenues and enhance expenditures in the social sector, the reform measures and associated fiscal transparency pertaining to the energy sector, and the steps initiated by the authorities to improve competition in the banking sector are all welcome.

We encourage the authorities to carefully monitor the revenue developments, given the uncertainty associated with the oil sector. In this regard, we also encourage production diversification.

> The gross reserve coverage at a comfortable 4.8 months of non-oil imports is encouraging. We support the ANB's intention to continue its exchange rate policy of managed float.
>
> We also welcome the intention of the authorities to accept obligations under Article VIII, and their efforts to accelerate accession to the WTO. We hope these measures will propel the program toward its objectives and drive the economy on a sustained growth path.
>
> We are happy that the authorities have developed procedures to monitor the program in order to prevent delays and problems of not meeting benchmarks. We also support the authorities' request for further technical assistance to enhance government capacity in designing and implementing fiscal and monetary policies, strengthening the banking sector, and maintaining a good strategic base, which are essential for effective macroeconomic management.
>
> In conclusion, we wish the authorities all the success in their policy endeavors.

The staff representative from the World Bank (Mr. Petersen) agreed that the privatization needed to be properly sequenced and paced. The Bank had been pursuing a parallel track with the IMF in the energy and water sectors through the proposed second structural adjustment credit. To strengthen the viability of companies in those sectors, the program included measures that target a 30 percent reduction in losses through improved collection rates, higher tariffs, or greater operating efficiency.

The Bank had been helping the authorities to strengthen the regulatory framework, as well as to design a viable tariff policy over the next years, while strengthening the social safety net, the staff representative continued.

On the privatization process, the authorities had agreed to follow World Bank recommendations, both in the hiring of the financial, technical and legal advisors, and in the overall conduct of the transaction, the staff representative remarked. The process would take 18-24 months, and would include analyses of the environmental liabilities, as well as of the social impact of privatization. The process could result in the signing of management contracts, with concessions of five or more years.

To support the development of the non-oil sector, the Bank had been helping the authorities to strengthen the business environment, including financial accountability in the private sector, the staff representative continued. The Bank had also been supporting the authorities' second privatization program—which was quite ambitious—using a multipronged approach. However, privatizing the industrial sector might prove difficult, given the state of the industry.

To provide the infrastructure for the private sector, the Bank had been working with the authorities to formulate a public investment program, the staff representative said. A presidential decree had set the deadline for completing the PIP in two months' time.

The staff representative from the European II Department (Mr. Wakeman-Linn) said that it was important to note that the pace of privatization in the energy sector was being driven by the authorities themselves, and not by the Bank or the Fund. Privatization had to be an important part of a comprehensive program to bring in financial investments and rehabilitate the energy sector infrastructure. Key to fundamentally addressing the problems in the energy sector was improving payments discipline, which could be ensured by a private company with a financial interest in those collections.

Concerning growth in the non-oil sector, the staff representative said that the growth of the Azeri economy in 2001 had been fairly broad-based, with the communications sector growing by 14 percent, agriculture by 11 percent—led primarily by wheat—and retail trade by 10 percent. There had also been substantial growth in the energy sector.

On investment policy, the Ministry of Economic Development had prepared a ten-year development strategy, which could provide important input for two other documents: the PRSP and the public investment program, the staff representative remarked.

On the oil fund, the authorities had committed to spend only for administrative expenditures in 2001 from the fund, the staff representative explained. They had decided to limit future expenditures from the oil fund to activities included in a government-approved investment program. As the public investment program was not yet ready, the authorities had decided to spend $35 million from the oil fund in 2002 to address the needs of refugees and internally displaced persons. The authorities intended to have a preliminary PIP ready soon.

On regional issues, the staff representative explained that the staff report had addressed those issues with the greatest macroeconomic importance, including those related primarily to energy trade and distribution. The staff would include more discussion of regional issues in the next Article IV consultation staff report.

There were a number of steps being undertaken in close cooperation with the World Bank to enhance governance in 2002, and particularly to make the Chamber of Accounts a supreme audit institution that could effectively audit and evaluate government offices, the staff representative said. The parliament was also in the process of debating an anticorruption law. The government had also adopted a comprehensive reform program for the customs committee, based on the recommendations of the external evaluation.

Ms. Vtyurina wondered about the factors causing the high interest rates in Azerbaijan.

Mr. Baukol inquired about the timing for the privatization of International Bank and United Universal Bank.

The staff representative from the European II Department (Mr. Wakeman-Linn) said that there were two reasons for the high interest rates in Azerbaijan. First, the economy had recently gone through a period of hyperinflation, which, as the experience of several countries had shown, was usually accompanied by a long period of high real interest rates. Second, the accounting system in Azerbaijan was inadequate, and it was difficult to use collateral and enforce bankruptcy. The authorities had been addressing those issues but they would not be resolved quickly.

With regard to the timing of the privatization of banks, the staff said that International Bank was currently 49 percent privately owned, and that the authorities were attempting to sell 20 percent of the government's stake to a strategic investor, preferably the EBRD. Once the 20 percent government share was sold, the authorities would decide, in the context of the end-March structural performance criterion, what to do with the remaining 30 percent government share.

The authorities were at a much earlier stage of the privatization process with regard to United Universal Bank, which was in the process of being rehabilitated, the staff representative remarked. The staff had agreed with the authorities to develop a timetable and a strategy by end-March for preparing United Universal Bank for privatization.

Mr. Cippà made the following concluding statement:

> Let me thank the Board for the interesting discussion and valuable comments and advice, which my authorities will surely take under serious consideration. As mentioned by the staff and emphasized by many Directors, recent progress has been quite impressive, both in terms of stabilizing the economy and in structural reform. In general, program implementation has been strong, with all policies subject to performance criteria implemented as planned. There were only some minor and temporary delays, but this did not have an impact on the objectives of the program. In this respect, I am grateful to the Board for granting the necessary waivers and allowing the conclusion of the review.
>
> In addition to macroeconomic stability, the program has two main objectives. The first is to improve governance and transparency, and the second is to promote economic growth in the non-oil sectors of the economy, which is the most employment-sensitive sector and is seen as the key to sustainable development and the elimination of poverty in the country.
>
> What has been done in past months is not enough. But it brings us many steps forward in achieving our objectives. We will just mention a few of those undertakings: the staffing, funding and expansion of the authority of the Chamber of Accounts; the various laws and decrees passed in relation to procurement, transparency and tax administration; and perhaps, more importantly, the program to enhance financial discipline in the energy sector.

Much remains to be done, and many risks still lie ahead that could jeopardize the success of Azerbaijan's transition. However, my authorities are committed to finishing the job and, with the help of the Fund and the whole international community, they believe that they will succeed in transforming and modernizing the economy—above all, in improving the well-being of the whole population of Azerbaijan.

The Fund has been instrumental in this endeavor, and my authorities are very grateful to management and to the staff for their valuable work and assistance, and for the constructive approach they observe in their dialogue with the authorities. They look forward to continuing this fruitful cooperation.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for Azerbaijan's continued strong economic performance in 2001, and noted that, despite the slowdown in the international economy and the reduction in oil prices, real GDP growth has been sustained at a high level. The authorities' economic policies contributed to low inflation and a positive consolidated government budget balance. Directors felt that the prospects for broad-based economic growth and low inflation are encouraging. However, in light of the continuing uncertain prospects in the energy sector, Directors stressed that economic diversification over the medium term should remain a crucial policy objective of the authorities in order to sustain a lasting reduction in poverty.

Directors agreed that the authorities' fiscal stance for 2002, which is somewhat tighter than originally envisaged, remains appropriate in the present circumstances. Nevertheless, they advised the authorities to carefully monitor revenue developments, and to be prepared to adjust the budget if developments—particularly those related to the oil sector—turn out to be less positive than currently expected. They also urged the authorities to take steps to improve revenue collections and expenditure management, and welcomed the increase in the share of expenditures going to education, health and social protection.

Directors welcomed the adoption of a comprehensive plan to strengthen financial discipline in the energy sector, noting that failure to reduce the large quasi-fiscal subsidies in this sector would threaten both the economic stability already achieved as well as the further broadening of economic growth. Directors were particularly encouraged by the decision to incorporate into the state budget the subsidies provided by the State Oil Company of the Azerbaijan Republic (SOCAR) to the utility companies, which they consider a crucial step toward fiscal transparency and enhanced financial discipline. Directors emphasized the importance of the authorities' commitment to develop a timetable for the gradual elimination of the spread between domestic and export prices for natural gas, crude oil and oil products.

Directors were encouraged by the adoption of regulations and procedures to ensure the integrated planning, execution and monitoring of the oil fund and state budgets in the context of a consolidated budget. Directors urged the authorities to develop a prioritized Medium Term Expenditure Framework and Public Investment Program to guide the utilization of oil fund assets, stressing that the oil fund, if used wisely, can make a crucial contribution to combating poverty in Azerbaijan.

Directors considered that monetary policy should continue to target a low rate of inflation, and that the exchange rate should remain market-determined. They welcomed the ongoing efforts to strengthen the banking system, including through improved banking supervision and raising the share of foreign banks, and the progress in the rehabilitation of the state-owned United Universal Bank. They encouraged the authorities to complete the privatization of the International Bank of Azerbaijan in order to create a competitive banking system in Azerbaijan. Directors praised the measures the authorities have taken to eliminate funding sources for international crime and to prevent money laundering.

Directors commended the authorities for the progress made in improving governance in 2001, with the expansion of the authority of the Chamber of Accounts, the passage of an improved procurement law, and the commitment to public reporting and auditing of the activities of the oil fund. Directors also welcomed the completion of the external evaluation of the Customs Committee and the adoption of a reform program on the basis of that evaluation, and encouraged the authorities to move forcefully with its implementation.

Directors noted the progress made in the preparation of the Poverty Reduction Strategy Paper, and urged the authorities to make every effort to develop a high-quality poverty reduction strategy in a fully participatory manner.

Directors stressed the need to improve macroeconomic and social data. They welcomed the steps that the authorities have taken in this regard in recent years, and urged them to continue their efforts to strengthen the statistical system and to ensure the timely dissemination of statistics. Directors welcomed the authorities' intention to accept the obligations of Article VIII, Sections 2, 3, and 4.

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

Additional Comments Relating to the Completion of the First Review Under the Poverty Reduction and Growth Facility

Directors commended the authorities for Azerbaijan's strong economic performance under the program. However, they regretted that several performance criteria related to structural reforms were not implemented on time. Directors granted the necessary waivers of performance criteria to permit the disbursement to take place, and concluded the first review under the PRGF.

Directors welcomed the adoption of regulations designed to integrate the oil fund and state budgets into a consolidated budget and urged the authorities to develop a meaningful, prioritized Medium Term Expenditure Framework and Public Investment Program to guide the utilization of oil fund assets. Directors stressed that, given the size of the quasi-fiscal subsidies in the energy sector, enhancing financial discipline in this sector is the most critical part of the government's reform program. They considered the decision to incorporate the subsidies provided by the state oil company to the utility companies into the state budget to be a crucial step toward enhanced transparency and financial discipline.

Directors underscored that issues of strong ownership and good governance remained at the core of the program. They stressed the need to extend these efforts to include governance in the Customs Committee. In this context, Directors were encouraged by the recent adoption of a reform program for the Customs Committee.

Directors looked forward to the completion of the safeguards assessment by early March.

The Executive Board took the following decision:

1. The Azerbaijan Republic has consulted with the Fund in accordance with paragraph 2(e) of the three-year arrangement for the Azerbaijan Republic under the Poverty Reduction and Growth Facility (PRGF) (EBS/01/91, Sup. 3, 7/9/01) and paragraph 3 of the letter dated June 15, 2001 from the Prime Minister, the Minister of Finance, the Chairman of the National Bank and the Minister of Economic Development of the Azerbaijan Republic in order to review program implementation and reach understandings regarding the phasing and conditions for disbursements during the remainder of the first year of the arrangement.

2. The letter dated February 6, 2002 from the Prime Minister, the Minister of Finance, the Chairman of the National Bank and the Minister of Economic Development of the Azerbaijan Republic (the "Letter"), shall be attached to the three-year PRGF arrangement for the Azerbaijan Republic, and

the letter dated June 15, 2001, together with its Memorandum of Economic and Financial Policies (the "Memorandum"), shall be read as supplemented and modified by the Letter.

3. Accordingly, the following new provisions shall be added to the three-year PRGF arrangement for the Azerbaijan Republic:

a. the performance criteria specified in paragraphs 2(a)(i) through 2(a)(vii) for end-March 2002 shall be as set out in Table 1 attached to the Letter;

b. a new paragraph 1(cc) shall be added to read as follows:

"(cc) During the second year of the arrangement,

(i) the fourth disbursement under the arrangement, in an amount equivalent to SDR 12.87 million, will be made available on October 15, 2002 or earlier, at the request of the Azerbaijan Republic and subject to paragraph 2 below.";

c. a new paragraph 1(dd) shall be added to read as follows:

"(dd) The phasing of, and the conditions for, further disbursements during the second year of the arrangement shall be established in the context of the second review of the Azerbaijan Republic's arrangement with the Trustee contemplated in paragraph 2(e) below.";

d. the preamble to paragraph 2 shall be deleted in its entirety and replaced with the following: "Azerbaijan will not request any disbursement under this arrangement:";

e. a new paragraph 2(aa) shall be added to read as follows:

"if the Managing Director of the Trustee finds that, with respect to the fourth disbursement referred to in paragraph 1(cc)(i), the data as of end-September, 2002 indicate that the ceilings and floors referred to in paragraph 2(a)(i) through (vii) of this arrangement, as specified in paragraph 4 and Table 1 attached to the Letter, were not observed.";

f. a new paragraph 2(cc) shall be added to read as follows:

"If the Managing Director of the Trustee finds, with respect to the third disbursement, that, by end-March 2002, the Azerbaijan Republic has not carried out its intentions regarding:

(i) the adoption of a timetable, in consultation with Fund staff, for the unification of domestic and world market prices for oil, oil products and natural gas,

(ii) the adoption, in consultation with Fund staff, of a timetable for the gradual reduction of the number of specific import tariffs and the weighted average import tariff, consistent with the commitments in the Memorandum, and

(iii) the adoption of timetables for the full privatization of the International Bank of Azerbaijan and the preparation of United Universal Joint Stock Bank for privatization,

and, in respect of the third and fourth disbursements, that at any time through January 31, 2003, the Azerbaijan Republic has not carried out its intentions regarding

(i) the quarterly granting to SOCAR of tax credits, not more than 15 days after the end of each quarter, equal to the difference between the value of fuel delivered to Azerenergy and Azerigas and the amount of cash payments received from those companies,

(ii) the publication of these subsidy and tax credit decisions, and

(iii) the inclusion of these subsidies and tax credits in the quarterly publication on the execution of the consolidated budget, not later than 30 days after the end of each quarter,

as specified in paragraph 14 of the Letter; or"

g. a new paragraph 2(ee) shall be added to read as follows:

"Until the Trustee has determined, with regard to the fourth disbursement, that the third review referred to in paragraph 14 of the Letter has been completed."

4. The Fund decides that:

(a) the first review contemplated in paragraph 2(e) of the three-year PRGF arrangement for the Azerbaijan Republic is complete; and

(b) the Azerbaijan Republic may request the second disbursement referred to in paragraph 1(c)(ii) of the three-year PRGF arrangement for the Azerbaijan Republic, notwithstanding the nonobservance of the end-September 2001 structural performance criteria specified in paragraph 2(c)(i)-(iii) of the arrangement, and the nonobservance of the continuous performance criterion on non-accumulation of external payment arrears specified in paragraph 2(b) of the arrangement on the condition that the information provided by the Azerbaijan Republic on the performance under these criteria and on the implementation of the measures specified as prior actions in paragraph 14 of the Letter is accurate. (EBS/02/21, Cor. 1, 2/20/02)

Decision No. 12681-(02/17), adopted
February 20, 2002

DECISIONS SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/02/16 (2/13/02) and EBM/02/17 (2/20/02).

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 01/107, 01/119, 01/121, and 01/128 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by Assistants to Executive Directors as set forth in EBAM/02/22 (2/13/02) is approved.

7. TRAVEL BY MANAGING DIRECTOR

Travel by Managing Director as set forth in EBAP/02/19 (2/19/02) is approved.

APPROVAL: May 6, 2002

SHAILENDRA J. ANJARIA
Secretary