January 14, 2002
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 01/95

10:00 a.m., September 14, 2001

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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
A. Barro Chambrier	D. Ondo Mañe
	T.-M. Kudiwu, Temporary
T.A. Bernes	P. Charleton
M.J. Callaghan	D.C. Guinigundo
	N.J. Davidson, Temporary
R.F. Cippà	T. Skurzewski, Temporary
	R. von Kleist
	D.H. Kranen, Temporary
P.C. Padoan	H. Vittas
D.I. Djojosubroto	Low K.M.
V.L. Kelkar	V. Bhaskar, Temporary
W. Kiekens	
O.-P. Lehmussaari	Å. Törnqvist
R. Quarles	A. Baukol, Temporary
P. Duquesne	S. Le Gal, Temporary
A. Mirakhor	M. Daïri
	A. Lushin
H. Oyarzábal	S. Alcaide, Temporary
	S.P. Collins
M. Portugal	
	I. Usman
	Y. Patel, Temporary
	S.S. Farid, Temporary
Wei Benhua	
J. de Beaufort Wijnholds	Y.G. Yakusha
K. Yagi	H. Toyama
	Y. Saito, Temporary
A.G. Zoccali	O.A. Hendrick, Temporary

A.S. Linde, Acting Secretary
J. Prust, Acting Secretary
N. Hairfield, Assistant
J. Puig, Assistant

Also Present
IBRD: P. Rodriquez, Europe and Central Asia Regional Office; J. van Amsberg, Latin America and Caribbean Regional Office. European II Department: J. Odling-Smee, Director; L. Hansen, O. Havrylyshyn, M. Luecke, P. Mathieu, D. Owen, G. Pastor, T. Richardson, E. van der Mensbrugghe. External Relations Department: A. Gaviria, C. Lotze. Fiscal Affairs Department: A. Cheasty. International Capital Markets: J. Nystedt. Legal Department: F.P. Gianviti, General Counsel; R. Gordon, S.C. Ho, D.E. Siegel. Monetary and Exchange Affairs Department: A.M. Leone. Policy Development and Review Department: J.T. Boorman, Counsellor; M. Allen, Deputy Director; G. Bannister, D. Desruelle, L. Ebrill, M. Fetherston, S. Kashiwagi, A. Mourmouras, J. Seade. Secretary's Department: L. Hubloue, A. Mountford, P. Ramlogan, T. Turner-Huggins. Statistics Department: G. Barinshetein. Western Hemisphere Department: C.M. Loser, Director; M.E. Bonangelino, Deputy Director; A. Belaisch, P. Gerson, C. Paiva, L. Perez. Office of the Managing Director: A. Bauer, S.B. Brown, R. Moghadam. Advisors to Executive Directors: M. Beauregard, M.P. Bhatta, A.R. Ismael, N. Jadhav, A. Kapteyn, L. Palei, H.E. Phang, A.A. Tombini, F. Zurbrügg. Assistants to Executive Directors: D. Baasanhuu, P.A. Brukoff, V. de los Santos, N.H. Farhan, E. González-Sánchez, F. Haupt, I. Kupča, P. Lathouly, Y. Lissovolik, Liu Z., A. Maciá, B. Mellor, G. Nadali-Ataabadi, J. Nelmes, P.A. Nijsse, K.S. Oo, J.W. Ralyea III, A. Rambarran, K. Sazanov, J. Sigurgeirsson, N. Watanabe, Wei X.

1. BRAZIL—STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on Brazil's request for a Stand-By Arrangement (EBS/01/149, 8/29/01).

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

> The following additional information has become available since the circulation of the staff report, the Memorandum of Economic Policies (MEP) and the Technical Memorandum of Understanding for the Request for the Stand-By Arrangement on August 29, 2001. None of these items materially affect the analysis presented in the staff report or the MEP, nor do they alter the staff appraisal.
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> Recently released data continue to point to a slowing of economic activity, as envisaged in the macroeconomic framework of the program. Industrial production, industrial employment, and capacity utilization all fell in July (month-on-month, in seasonally adjusted terms). Despite the decline, July industrial production was actually stronger than anticipated in the program.
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> Inflation declined in August, with the broadest measure of consumer price inflation falling to 6.4 percent (12-month basis) from 7.1 percent in July. Other indexes of inflation have also declined in recent weeks.
>
> Slower domestic demand growth was reflected in an improved trade balance, which registered a surplus of US$625 million in August (raising the year-to-date surplus to US$663 million) due in large part to sharply lower imports (in seasonally adjusted terms). One-third of the monthly surplus arose from a one-time re-export of commercial aircraft. Excluding this transaction, exports remained stable in August, compared both to August 2000 and seasonally adjusted against July 2001. During the first 10 days of September there was a trade surplus of US$41 million.
>
> The Monetary Policy Committee of the Central Bank left interest rates unchanged at 19 percent at its August meeting, as it sought to balance concerns about slowing domestic demand growth against worries about still-high inflation and the potential for further pass through to prices of the depreciation of the real.
>
> On August 31, the authorities submitted a 2002 budget proposal to Congress that is consistent with the 3½ percent of GDP public sector primary surplus target for the consolidated public sector, as outlined in the proposed program.

> The Finance Ministry announced on September 5, 2001 that it was preparing a proposal to exempt stock market transactions from the financial transactions tax (CPMF), as foreshadowed in the MEP (paragraph 34).
>
> On August 30, 2001 the central bank released a revised series on external debt, which resulted in a reduction of US$30 billion in the debt stock to US$206 billion. The decline, which did not involve the external public debt, resulted from a reclassification of a stock of US$14 billion in intra-company loans as part of foreign direct investment (in line with the treatment for flows of intra-company loans prescribed in the Fund's current balance of payments manual) as well as a realization that some US$16 billion in private obligations that were included in the debt stock had in fact already been repaid.
>
> Following Tuesday's attacks on the United States, the stock market declined sharply, with the Bovespa falling 9.2 percent before trading was halted Tuesday afternoon in line with actions in other countries. The index recovered by 2.6 percent on Wednesday. The real depreciated on Tuesday and Wednesday, closing at R$ 2.69 per U.S. dollar on Wednesday, despite modest central bank intervention both days beyond the US$50 million daily interventions already announced.

Extending his remarks, the staff representative from the Western Hemisphere Department (Mr. Perez) reported that, on recent financial market developments in Brazil, the real had closed at 2.67 real per U.S. dollar on September 13, roughly unchanged from September 12, after having depreciated to 2.74 real per U.S. dollar by midday. The central bank had sold about 3 billion real worth of foreign currency-indexed bonds and had also intervened modestly in the spot foreign exchange market by more than $50 million.

The market had suffered in recent days from a shortage of liquidity, as market participants appeared to be awaiting the reopening of markets in the United States following the events of September 11, the staff representative continued. The central bank had informed the staff that the roll-over rate of foreign currency-indexed bonds had exceeded 100 percent because of the current exceptional circumstances. However, that would not reflect a change in policy. The stock market index had declined by 7 percent on September 13, and for the week as a whole, it had shown a cumulative decline of about 16 percent.

Mr. Portugal submitted the following statement:

> I wish to convey the appreciation of my authorities, and my own, to staff and Management for their hard work in negotiating the arrangement and preparing the excellent report on Brazil's request for a new Stand-By Arrangement. The financial support that my Brazilian authorities are requesting from the Fund is fundamental to buttress the recent strong policy measures they implemented to respond to temporary external and domestic shocks.

After performing remarkably well in 2000, the Brazilian economy has slowed down considerably in the first half of 2001 as a result of a combination of factors—among them the worsening of the global economic environment, the crisis in neighboring Argentina, and the domestic energy shortage manifested in the second quarter of the year. The authorities swiftly adjusted the macroeconomic policy stance and adopted other policy measures. These events, together with the required policy response, led to a temporary deceleration in the rate of growth of GDP from 4½ percent in 2000 to approximately 2½ percent in the first half of 2001, while unemployment remained relatively unchanged at 6.7 percent.

Since the implementation of the Real Plan in mid-1994, Brazil made major strides in its stabilization process and structural reforms, successfully bringing annual inflation down from four-digit to one-digit figures. The size of the public sector was substantially reduced through privatization. Trade liberalization was deepened through a substantial reduction of import tariffs and elimination of all non-tariff barriers. With the rapid reduction of inflation, and the accompanying fall of inflationary revenues, the financial system was submitted to a full-fledged restructuring, with unsound institutions being liquidated, merged or restructured and prudential regulation and supervision being updated.

The Brazilian privatization program, under implementation since the early 1990s, led to the unprecedented sale of over 100 companies operating in telecommunications, steel-making, chemicals, railroads, banking, and mining, yielding US$82.3 billion in revenues, which were used to retire public debt allowing the transfer to the private sector of another US$18 billion of debt. Trade liberalization efforts, consolidated in 1994 and early 1995, reduced average import tariffs from 32.2 percent in 1990 to 13 percent currently and, along with the effects of the stabilization program, generated a major impact on imports, raising them from around US$20 billion in 1990 to US$53 billion in 1996.

A major restructuring of the private banking sector took place from end-1994 to 1997. Around 50 banks of a total 268 went through restructuring, merger, or transfer of control. Another 43 institutions were placed under intervention. Foreign ownership doubled in this process, with foreign institutions' share of the financial system's net worth reaching 28 percent by end-2000. A line of credit of R$ 21 billion (PROER), established by the Central Bank (BCB), was essential for achieving this restructuring. Prudential regulations and supervisory practices were improved and substantial progress was made in strengthening the soundness of the financial system. While generating some increase in domestic public debt, yet relatively modest against the international evidence on costs associated with banking crises, this program proved essential in helping Brazil to withstand better the effects of the international crises in 1997 and 1998. Likewise, the soundness of the financial system was quite instrumental in enabling the country to a rapid recovery after the currency devaluation of early 1999.

Despite its success in keeping inflation at low one-digit levels, the stabilization program involved a too-gradual approach in addressing structural fiscal imbalances, leaving Brazil vulnerable to a capricious external environment.

In 1998, the international financial turmoil that culminated with the Russian moratorium produced a confidence crisis along with large capital flight from emerging markets, leading the Brazilian government to announce on September 8 of the same year a program to tighten the fiscal regime and to seek international support afterwards. This program produced a shift in the primary result of the consolidated public sector from a deficit of 1 percent of GDP in 1997 to a surplus of more than 3 percent of GDP in 1999.

Following strong pressures on foreign exchange reserves, the BCB was led to abandon the crawling peg to the dollar, and to float the real in early 1999. With substantial fiscal adjustment on the pipeline, and confronted by the overshooting of the real depreciation, the government tightened monetary policy and announced the decision to implement a full-fledged inflation targeting system to serve as the nominal anchor to the economy in a free-floating exchange rate regime. As the reversal in the initial overshooting of the exchange rate occurred, nominal rates were reduced accordingly and consistently with reaching one-digit inflation by the end of 1999. These policies allowed a smooth transition to the floating exchange rate regime without sacrificing price stability, while the negative impact on output was substantially lower than initially envisaged.

Significant progress was also made on fiscal structural consolidation. The privatization program, the debt rescheduling agreements with the states, and the implementation of the fiscal responsibility law will all help to lock-in and deepen in the long-term the gains of fiscal adjustment.

Under the existing Stand-By Arrangement, Brazil demonstrated both strong ownership and capacity to meet the program objectives and targets. The resolve of the authorities in the areas of fiscal, monetary, and exchange rate policies, and the timely and appropriate responses adopted to withstand the effects of a number of adverse shocks in the last three years allowed Brazil to meet all performance criteria, against a background of invigorated economic growth, improved social indicators, and strengthened social safety nets. The SRF funds borrowed from the IMF and from bilateral creditors were fully repaid, partly ahead of schedule.

Fiscal performance has been remarkable under the current program. As of June 2001, for eleven consecutive quarters, Brazil has met consolidated public sector primary surplus targets, some with substantial margin. The consolidated public sector reached a primary surplus of R$ 30.4 billion in June, ¾ of a percentage point of GDP above the corresponding performance criterion. In July, the primary surplus of the consolidated public sector reached R$ 33.1 billion, compared to the R$ 34.4 billion performance criterion for next September. This strong fiscal performance was observed on all levels of government, with the central government and its enterprises delivering 69 percent of the result and states and municipalities 31 percent. Reflecting the depreciation of the real since the beginning of the year and the increase in interest rates since March, public debt, which in Brazil is calculated on an accrual basis, immediately captured these impacts, part of which may be of a temporary nature, with the net public debt to GDP ratio increasing from 49.3 percent at end-2000 to 52.5 percent at end-July.

Despite the deterioration in financial conditions, debt management continued to improve the debt profile. The average maturity of outstanding competitive federal debt rose from 15.8 months at the end of 2000 to 22 months at the end of June 2001, while the average duration was increased from 6.3 to 9.7 months in the same period. Against a background of higher interest rate and exchange rate volatility and given the existing markets conditions, the share of both floating interest rate and dollar-indexed bonds had to be increased. While the sensitivity of public debt to changes in interest rates and exchange rate increases with a larger proportion of debt indexed to these variables, such composition of public debt greatly reduces rollover risks and has allowed the government to borrow domestically rather than abroad to meet the largest share of its financing requirements. However, consistent with the medium-term strategy of Brazilian debt management that is being applied since 1994, the authorities intend to reduce gradually the shares of floating interest rate and exchange rate indexed bonds, as market conditions allow.

As part of the new program, the Brazilian government announced a tightening of the primary surplus to 3.35 percent of GDP in 2001 and to 3.5 percent of GDP in 2002, from previously established levels of 3.0 percent and 2.7 percent respectively. The indicative targets for 2003 and 2004 have also been raised to 3.5 percent from 2.5 percent. This tightening of fiscal policy represents a significant new effort given the decline in GDP growth, the additional expenditures with the energy crisis and new mandated social spending, and considering the relatively inflexible structure of public expenditures. It is intended to prevent a further deterioration in nominal fiscal results in the short-run; and to restore the declining path of the debt-to-GDP ratio over the medium term. To achieve the revised fiscal targets, the government will focus primarily on the expenditure side, given the already high tax burden. Nevertheless, expenditure on priority social programs will be secured.

Within the framework of inflation targeting, monetary policy has consistently met its objectives. Under a multi-year target for headline inflation measured by the consumer price index (IPCA), the BCB has achieved its targets in the last two years, with actual inflation lying comfortably within the tolerance band in 1999 and at the target in 2000. Monetary policy under inflation targeting has been transparent and consistent with the achievement of its objective, working as an important instrument to coordinate expectations, even under adverse circumstances.

Inflation in 2001 has been affected by the pass-through of the exchange rate depreciation and regulated price increases. In June the 12-month increase in IPCA reached 7.3 percent. As this was slightly above the upper-limit of the inner consultation band, the authorities consulted with the IMF staff, reaching a common understanding on the causes of such deviation and explained the fundamentals behind recent policy responses. Cumulative inflation up to July reached 4.3 percent, compared to a ceiling target of 6 percent for the year 2001.

Monetary policy responded swiftly to higher-than-expected inflation. Given that the underlying causes of the recent inflation surge were basically related to temporary supply and external shocks, the BCB allowed for the initial drift in the price level, but responded aggressively to limit the second round effects of such shocks. Since mid-March 2001, the Monetary Policy Committee (COPOM) has implemented a series of rate increases amounting to 375 basis points, leading to a 19 percent per year policy rate. Market rates have been adjusted even further since then, producing a substantial impact through the demand and credit channels, bringing inflation projections in line with the 3.5 percent inflation target for 2002, even against an adverse external scenario. In a changing environment and in the context of a floating exchange rate, the BCB will continue to act preemptively by adjusting its policy instrument on a forward-looking basis to pursue the inflation targets.

In line with the deterioration of world economic growth, international financing conditions and with problems in the energy sector, the balance of payments outlook has been revised since the beginning of the year. This revision has been affected by a more depreciated exchange rate, slower economic growth in Brazil, less than buoyant export market, and increasing risk aversion abroad. The qualitative results of such revision indicate a better than initially expected trade result, in part compensated by higher remittances of profits and dividends, resulting in a slight improvement on the projected current account deficit for 2001. Regarding FDI flows, there has been a downward revision, but these flows will still account for a large portion of the projected current account deficit. Brazil’s access to international capital markets remains comfortable, despite the widening on sovereign spreads since the beginning of the year. International sovereign bond issuances by Brazil totaled US$6.7 billion, exceeding by 65 percent the central government amortization requirements for this year.

In order to strengthen the balance of payments financing prospects, the government announced a number of initiatives, prior to requesting the new Stand-By Arrangement. Among them the drawing in June of US$2 billion under the existing program, the decision to augment sovereign bond issues, and the sale of government owned shares in public and privately owned enterprises.

The government also announced in early July, the sale of US$6 billion in the spot foreign exchange market during the remainder of the year, on regular daily sales of around US$50 million. The authorities will not intervene in the foreign exchange markets above these levels, except if extraordinary circumstances occur. The lowering of the NIR floor to what it had been during the 1998 crisis is essential to positively affect expectations concerning the preparedness for the eventuality of any major additional disruptions in the external economic outlook.

In the beginning of the second quarter, it became clear that the electricity supply would not be enough to match the demand during the remainder of the year in the northeast and southeast regions of Brazil. This was mainly the result of the worst rainfall summer season over the last 70 years, which reduced the average peak level of reservoirs to 35 percent of capacity compared to 60 percent in 2000. While the increase in generation capacity between 1996–2000 was almost three times higher than in 1991–95, and the largest of any five-year period over the last two decades, growth in investment has also lagged behind a fast growing demand. As 93 percent of total electricity supply in Brazil is produced by hydroelectric plants, this situation necessitated an urgent emergency response. The government put in place a plan that involved, on the demand side, a reduction in consumption of 20 percent to be brought about mainly by price measures. On the supply side, the plan calls for improvements in the wholesale market for energy to allow firms sell their unused quotas to other businesses at freely negotiated prices, enhancements of the regulatory framework for thermo-electricity, short-term supply initiatives and a medium-term investment program. The latter is destined to increase the generation capacity by 25 percent up to 2003, involving investments of around 2.5 percent of the GDP, of which about 70 percent will be carried out by the private sector.

The response of the Brazilian population to the demand restraining measures has been remarkable and electricity consumption fell by 19 percent in June, 22 percent in July and 19 percent in August as compared to April 2000, mainly household consumption, which should mitigate the impact of such reduction on GDP growth. With the implementation of the plan, if hydrologic conditions in the new summer season next December match again the worst case of the last 70 years, the need for rationing next year would be of 5 percent of consumption. If hydrologic conditions turn out better than the worst case of the last 70 years, the need for reducing consumption could be diminished or eliminated.

Good progress was achieved on the structural front since the last review, and the government will continue to pursue the completion of its structural reform agenda within the timeframe of this arrangement. In the financial sector, the in-depth audits of the federal banks have been completed, and the government has begun to implement a comprehensive strategy to strengthen these financial institutions. As a result of the transfer of high risk and low-yielding assets to the Treasury and the capitalization of three of the four banks, the capital adequacy ratios of the banks are all above the minimum 11 percent regulatory floor. The capitalization will generate an increase in the debt to GDP ratio of 1 percentage point. In addition, measures to improve the corporate governance of these banks are been taken with the objective of separating their commercial activities from the relatively unprofitable lending to agriculture and housing, recording the subsidies to these sectors fully in the budget.

The government is also in the process of concluding the program for the resolution of banks previously owned by the states (PROES) during the new Stand-By Arrangement, with the privatization of the remaining six state banks that are currently under federal administration.

The government is also considering the possibility of bringing the regulation and supervision of stock exchange, insurance and pension funds, presently undertaken by three separate agencies, under the responsibility of a single agency to improve the effectiveness of capital market supervision. The authorities have also requested to participate in the FSAP.

The authorities will seek to move forward the reform of indirect taxation through a constitutional amendment establishing a national legislation for the state-level value added tax, as well as an explicit system of taxation for oil products to replace the implicit tax embodied in the so-called oil account. In addition, the government has submitted legislation to improve the refund system for two cascading indirect taxes (PIS and COFINS), with a view to eliminate their implicit bias against exports. The authorities have requested a fiscal ROSC mission, which is currently in Brasilia, and intends to continue seeking technical assistance from the Fund in the fiscal area.

In the area of corporate governance, the government is seeking approval of three important bills already in Congress: a new corporate law aimed at strengthening the protection of minority-shareholders rights, a new bankruptcy and insolvency law, and a law improving the quality and transparency of accounting standards for corporations. On September 4, 2000 important reforms have also been introduced in the housing financing system, improving guarantees for the financial agents, broadening the financing instruments available to the sector and allowing indexation to price indices of long-term housing loans.

Efforts in the area of trade liberalization and regional integration within Mercosur continue to have a high priority on the government's policy agenda, despite recent difficulties. Brazil also remains fully committed to multilateral trade liberalization and to strengthening a rules-based global trade system.

While major progress has been achieved in macroeconomic performance and structural reforms over the last eight years, the Brazilian government is conscious of the substantial challenges that still lie ahead. In particular, my authorities are aware of the potential risks embedded in the current international environment and prepared, as always, to adjust policies if conditions deteriorate further. They are determined to achieve further sustained growth of output and employment, to maintain a sustainable external position, and to improve the living standards of the population—especially in low income groups—in a context of declining inflation.

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

The Brazilian economy continued to perform relatively well in the first half of 2001, aided by prudent macroeconomic policies, which, together with the steady progress in the implementation of structural reforms, helped maintain economic stability and strengthened the economy's resistance to adverse developments in the external environment. Beginning with the second quarter, however, Brazil was impacted by a domestic energy crisis, financial contagion from Argentina, and the more general slowdown in the world economy. This was reflected in a slowdown in growth, a significant depreciation of the real, higher than programmed inflation, widening bond spreads, and a general weakening of market confidence. The authorities are to be commended for their strong policy response, which included a tightening of monetary policy, the initiation of a domestic energy saving plan, and a strengthening of structural reforms in the financial system. The proposed economic program before us today builds on Brazil's strong adjustment and reform effort over the past few years, and stands to further strengthen economic fundamentals in the face of a challenging external environment. In view of the authorities' demonstrated strong commitment to their reform agenda, we fully support their request for a replacement Stand-By Arrangement. We are in broad agreement with the staff appraisal and shall limit our comments to key areas of concern.

On the fiscal front, we commend the authorities for their impressive fiscal performance in the first half of 2001, with the primary surplus of the consolidated public sector exceeding the programmed target. This reflected continued expenditure restraint and a strong revenue performance at all levels of government. In view of the unfavorable external environment, and the limited progress on inflation this year, we welcome the authorities' intention to preserve this fiscal over-performance by raising the fiscal surplus target for the year. This is to be achieved by the state and public enterprises, in view of the rigidity of federal government spending. A more ambitious fiscal consolidation effort will be needed in 2002 and beyond, to ensure that the debt dynamics remain under control and to place the ratio of debt-to-GDP on a firmly declining path. Accordingly, we are pleased to note that the consolidated public sector surplus target for 2002 is being raised to 3.5 percent of GDP and is to be maintained at that level through 2004. We are somewhat concerned, however, that the 2002 additional expenditure adjustment, to be effected at the federal government level, is concentrated on capital outlays which will decline by 20 percent from their already low level in 2001. This points to the need to seriously address the increasing rigidity of federal government outlays, which are obviously constraining the government's fiscal consolidation efforts. The public debt dynamics are further complicated by the rising share of exchange rate-indexed and floating rate securities. We encourage the authorities to continue their efforts, noted in Mr. Portugal's informative statement, to reduce the shares of these bonds in public debt, and to build on the commendable progress already achieved in increasing the average maturity and duration of the debt stock.

On structural fiscal reforms, we commend the authorities for their commitment to move forward on reforming the tax system and improving revenue efficiency. Moreover, pension reforms are well underway with one remaining legislation expected to be approved by congress in the coming few months. We also encourage the authorities to move forward with their strategy of administrative and civil service reform, in order to ensure the release of resources needed for discretionary spending on infrastructure and priority social spending.

On monetary policy, in response to higher than expected inflation, the central bank has appropriately tightened monetary policy beginning last March. The decisions to raise interest rates were well timed, and reflect the authorities' credible policy commitment to the inflation-targeting framework. At the same time, we note the authorities' full commitment to the floating exchange regime, and welcome their intention to limit foreign exchange intervention during the year to the 6 billion level already announced—except of course in extraordinary circumstances. These limited interventions, together with the authorities' forward looking inflation targeting framework with clear and transparent communication to the public, should give positive stabilizing signals that will contribute to improving market confidence. In this context, while we hope that extraordinary circumstances will not materialize, the lowering of the NIR floor provides a reasonable level of flexibility to the authorities in case of major disruptions to the external economic outlook. This should positively affect market expectations.

On structural reforms, we welcome the authorities' continued commitment to reforming the financial sector. A number of encouraging steps are underway to improve capital market supervision, corporate governance, and enhance the regulatory framework for banks. The drafting of a new central bank law is also a crucial step towards enhancing central bank operational independence; and the ongoing efforts to restructure the federally owned commercial banks, including reforms to their management, will pave the way for the completion of the cleanup operation for the financial institutions of state governments, thus resolving a major contingent fiscal liability. In the energy sector, efforts to address the sector's problems on a permanent basis should include measures that allow for further adjustments in energy prices, and encourage private sector participation in the sector.

To conclude, we commend the Brazilian authorities for their accomplishments and their strong determination to maintain the reform momentum. With a global economic slowdown underway, and the threat from regional contagion continuing to cloud the horizon, we welcome the authorities' readiness to adjust macroeconomic policies as needed. We wish them success in the challenging period ahead.

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

Aggravated external environments, including the Argentine and energy crises, have caused Brazil to watch the value of its real falling significantly and the spreads on sovereign bonds expanding. In response to heightened inflationary pressures stemming from the depreciation of the currency, BCB raised interest rates by a cumulative 375 bps. and intervened in the foreign exchange market to meet the inflation target. Moreover, the depreciation of the real and the rise in interest rates have adversely affected the dynamics of the public debt, as a significant portion of outstanding government bonds are composed of foreign exchange indexed and floating rate securities. This calls for the need to tighten the fiscal position further.

Given this background and considering the increasing likeliness that the world economic slowdown will be prolonged and will put at significant risk the Argentine authorities achieving the goal of their economic program despite the Board's approval of the augmentation last week, we think the Brazilian authorities' decision to apply for a new Stand-By Arrangement precautionary, when the country has met with little difficulty its balance of payments at this point, is prudent. The proposed new program incorporates, what we think are, appropriate measures to strengthen resiliency against external shocks, including a further step for fiscal consolidation. We support the proposed decision.

We would like to take up several issues that the authorities should consider in carrying out the proposed program. It is always difficult to find a clear solution to dilemmas when pursued goals conflict with each other, but we would like to encourage the authorities to stand firm in addressing each issue. First, there is the dilemma of how much fiscal policy should be set pro-cyclical in order to maintain market confidence. While it is appropriate that principal measures for fiscal consolidation are not sought on revenue increases, but on expenditure cuts, it will be necessary to secure measures to minimize adverse impacts on growth and social solidarity. In this vein, it would be appropriate for the proposed program to prepare an increased budget for the socially vulnerable while cutting expenditures for investments, except for the energy sector. We wonder, however, why salaries for civilian government workers that have remained unchanged for six years must be increased. We think a salary freeze for another year would be more appropriate, not only for securing more room for further fiscal consolidation when necessary, but also for containing inflationary pressures.

Second, the authorities are faced with the dilemma of choosing between inflation targeting and the floating regime. Inflation targeting was introduced as an anchor for monetary policy at the time the exchange regime was changed, but at this time when the slowdown of the economy and heightened inflationary pressures co-exist, the benefit of the floating regime that depreciation of the currency would bring recovery to competitiveness would be offset by the fact that inflation targeting would require the central bank to increase interest rates and/or buy its own currency in the exchange market. While credibility in the central bank would be at stake if it misses the target, sticking to the target by implementing a pro-cyclical monetary policy might have substantially adverse impacts on growth and/or rapidly reduce international reserves. It seems to us that it is because the authorities and staff duly recognized this dilemma that they agreed on setting a higher central point for the purpose of consultation mechanism than the official inflation target. We can only urge BCB to strike an appropriate balance between the mutually conflicting considerations in view of the developing situation, but perhaps what is utmost important is for the central bank to fully explain the background of its policy choice to the public when it makes a policy decision. Monetary tightening thus far has already slowed down credit expansion to the private sector, and according to Figure 4, nominal bank intermediation spreads for enterprises have increased since the end of last year. A reduction in large spreads in Brazil has been a long-standing issue to make the financial sector efficient and improve the monetary policy transmission mechanism. We would like staff to explain why the downward trend in spreads has changed its course. More stringent lending stance by banks? Or an increase in inflation expectations?

Third, over the medium to long term, Brazil and Argentina must adopt an exchange rate regime and policy mix that make the two economies compatible. It is hard to deny that the Brazilian recovery from this crisis through a shift to the floating regime has as its reverse side Argentina's losing momentum for growth due to the increase in effective exchange rates. At the same time, it is apparent that a critical situation in Argentina would have adverse impacts on Brazil. Therefore, it is imperative that the two core Mercosur countries should not be preoccupied with insulating themselves from one another's crisis, but should share the stance that the macroeconomic framework for mutual prosperity should be sought in both countries. While each country should endeavor to run sound macro-economic management and overcome its own vulnerability, both countries should seek to enhance competitiveness of their industries in a more integrated market rather than trying to strengthen their relative competitive condition. The Fund stands in the best position to address this consideration as it consults with authorities of both countries on their programs.

Finally, the availability of funds under the proposed Stand-By Arrangement would provide breathing room until confidence is restored in case Brazil loses access to the credit market. Against the depreciation of the real, monetary policy should be employed to tighten monetary conditions further. More important, fiscal tightening should be strengthened. We wonder, however, if it might become necessary to address the rigidity of the expenditure structure to pursue further tightening. Given the already limited room for discretionary cuts, the authorities might well study the possibility to amend the constitution and laws that provide for mandatory expenditures. We would like to hear staff's comments on this point.

With these remarks, we wish the authorities every success.

Mr. Oyarzábal and Mr. González-Sánchez submitted the following statement:

At the outset, we thank staff for the well written report on Brazil and Mr. Portugal for his very informative statement. Brazil's economic performance under its current Stand-By Arrangement has been strong, but the deterioration of the global economic environment, recent developments in Argentina, and domestic problems in the energy sector have weakened market confidence in the country. This has been evidenced by the substantial depreciation of the real and the significant widening of bond spreads since the beginning of this year. In this framework, the authorities have requested the cancellation of the current Stand-By Arrangement and its replacement by a new 15-month Stand-By Arrangement that would end in December 2002. We support the proposed decision and consider that the key elements of the new program are appropriate. The program is designed to provide resources, if necessary, to increase gross reserves in case of continuing deteriorating financial conditions. Needles to say, continued fiscal consolidation, a tight monetary policy stance, and advances in the structural reform agenda are also essential to cope with the difficult external and domestic environment. We agree in general with the staff appraisal and would like to make the following comments mainly for emphasis.

Fiscal performance has been substantially better than programmed, with the primary surplus of the consolidated public sector exceeding the target under the existing Stand-By Arrangement and the new program envisaging a further tightening of fiscal policy. In this connection, we are encouraged by the fact that although the tightening of fiscal policy is to be achieved primarily through expenditure control, priority social spending and investment to resolve the energy crisis will be protected. Indeed, we learn from the staff's report that the central government's 2002 budget proposal actually increases social spending, especially in the health and education sectors, as well as on poverty alleviation programs. We concur with the authorities and the staff that considering that the revenue-to-GDP ratio is already high, the strategy to achieve a higher primary surplus should rest on expenditure control.

The tightening of fiscal policy will also contribute to keep the debt dynamics under control and put the debt/GDP ratio on a downward trend. It is important to note that debt dynamics have been complicated by the large fraction of the domestic debt that is foreign exchange-indexed or at floating interest rates. Although this composition of the domestic debt facilitates its rollover and reduces refinancing risks in periods of crisis, it also contributes to keep the debt-to-GDP ratio high. Furthermore, volatility in exchange and interest rate markets can be substantial in the present uncertain environment, making the management of domestic debt more difficult. Thus, we encourage the authorities to persist in their efforts aimed at reducing the shares of floating rate and foreign exchange indexed bonds. We are encouraged that the BCB stated that it will limit any increases in the outstanding stock of U.S. dollar-indexed bonds and will seek to reduce the volume of these instruments as market conditions permit.

Although end-year inflation might exceed the upper limit of 6 percent for the inflation target, affected by the pass through of the exchange rate depreciation and regulated price increases, the inflation targeting framework appears to be functioning well. We consider that the rise of interest rates by the authorities in response to the higher-than-expected inflation is adequate, and fits into the strategy to bring inflation down to 3.5 percent by the end of 2002.

The floating exchange rate regime in place in Brazil has served the country well—by providing a very useful instrument for shock adjustment—and we welcome the authorities' commitment to it. Given the particular circumstances of the region and the need to limit contagion, the establishment of a NIR floor below that one under the current Stand-By Arrangement is an adequate measure.

Although some 90 percent of the current account was covered by foreign direct investment (FDI) during the first half of 2001, some caution is in order, since both FDI and portfolio investment were about 8 percent lower in that period compared with the same period a year earlier, and as stated by Mr. Portugal in his statement, there has been a downward revision of FDI flows.

On structural reforms, we welcome the emphasis on the financial sector, with measures aimed at improving supervision of capital markets, revise laws on bankruptcy and corporate governance and enhance the operational autonomy of the BCB. Structural reforms in the fiscal sector are also necessary, and we are encouraged by the implementation of legislation to reform the tax refund system for two indirect taxes, seeking to reduce their cascading effects and eliminate their bias against exports. We urge the authorities to make the appropriate adjustments to the regulatory framework for private investment in energy generation, in a way that private investment in the sector is encouraged.

We welcome the authorities' intention to participate in the FSAP, as well as the work on measures that encourage the gradual adoption of internationally accepted accounting practices.

Finally, we commend the authorities for their close contacts with the international investor community through diverse ways that include the internet, road shows and conference calls. This strategy enhances and promotes transparency and trust between the country and market participants, thus contributing to prevent undesirable disruptions in the markets. We wish the authorities continued success in their policy efforts.

Mr. Bernes submitted the following statement:

I would like to thank the staff for a good report on Brazil. The proposed program is well designed and based on reasonable macroeconomic assumptions for 2001 and 2002. Most importantly, the authorities have sound policy frameworks and have been taking broadly appropriate policy actions in response to major exogenous shocks—both financial and real—under heightened uncertainty. I am also heartened by the authorities' intention to treat the program as precautionary, and the fact that performance criteria under the existing program were met, and previous SRF purchases were repaid early. For these reasons, I support the proposed new arrangement.

The authorities are understandably concerned about the evolution of the real. It has depreciated by almost one-third since the start of the year, and it has been plumbing all-time lows almost on a regular basis. The depreciation of the currency is more problematic in Brazil than in most countries given that 27 percent of the public sector debt is linked to it. A depreciation that is resisted with higher interest rates is also harmful to the fiscal balance as 50 percent of the debt stock is comprised of floating-rate securities.

Since the beginning of July, the central bank has relied on daily injections of US$50 million in the foreign-exchange market to try to smooth movements in the exchange rate. In total, the central bank is ready to provide up to US$6 billion in funds to the foreign exchange market by the end of the year. However, it is hard to see what good this policy has achieved, other than to drain the central bank's reserves. The trend depreciation of the real is virtually unchanged from the pre-intervention months, and it is not clear that its volatility has been much affected.

Moreover, one of the most significant shocks affecting Brazil is financial in nature—as the staff noted, a weakening of market confidence related to increased uncertainty in the international environment. The risk premia demanded by financial market participants in connection with this shock most likely reflect heightened concerns over the prospects for inflation and creditworthiness, and such risk premia are driving the depreciation of the real and the rise in interest rates. It is not likely the result of increased liquidity risk, as the authorities seem to allude to in explaining their intervention policy.

It is hard to see, therefore, how daily intervention will help to reverse the increase in risk premia. Worse, market participants might be led to the false conclusion that such interventions are designed to provide some sort of an implicit guarantee on the value of Brazilian assets. However, as the authorities themselves recognize, this would be inconsistent with the basic tenets of a floating exchange rate regime.

I think a better use for these resources would be for the BCB to reduce the outstanding stock of government debt. Markets are concerned about Brazil's vulnerability to movements in the exchange rate and overnight rates to the extent that they affect debt servicing. In this light, a reduction in the stock of debt would send a better signal to markets than foreign exchange intervention. In 2002, if the government were to use the full US$ 6 billion (a portion of which is already spent) to reduce its public-sector borrowing, the government could reduce its reliance on debt markets by a significant margin (around 25 to 30 percent). Moreover, given recent concerns that FDI may weaken further, these resources could provide a cushion to 2002 financing requirements.

On the inflation front, the staff report seems to all-but-admit that the inflation target for end-2001 will be overshot. This is fully appropriate, given the lags in the transmission mechanism, and it is generally in line with inflation targeting best practice. However, I have some concerns over the attainment of the 3.5 percent year-end target for 2002. The real has depreciated about 33 percent since the beginning of the year, and only a portion of that has been passed through to the inflation rate. Most estimates of the pass-through in Brazil place it at about 20 percent, with a lag of 12-24 months. This could lead to substantial inflationary pressures in 2002. The depreciation could push up prices over and above the underlying rate of inflation by about 6.5 percentage points in 2001–2002.

Under these circumstances, the authorities are right to accommodate some of the initial price-level drift, but aggressively limit the potential for a second round impact on inflation pressures, as Mr. Portugal explains in his statement. The rationale underlying this course of action needs to be communicated very clearly to the public. I would be very cautious, however, about any expectation that monetary easing could be undertaken next year, as the staff suggest, especially early next year. Confidence intervals are wide, and with the potential for inflationary pressures, a premature easing may end up having to be more than reversed subsequently. In the end, such a situation would undoubtedly be more costly, both in terms of debt-service costs, and in terms of policy credibility.

I think it would be fair to say that, if anything, Brazil's Achilles heel is its public debt profile. As noted above, Brazil continues to rely heavily on floating rate and exchange-rate-indexed securities. In fact, the use of dollar-linked debt has increased since 1999. The government realizes that the use of such debt instruments can be problematic when the real depreciates. Yet, as explained in Box 2 of the staff report, the fiscal authorities actively use exchange-rate-indexed instruments in times of exchange-market volatility as a source of hedge for investors, and in an attempt to reduce volatility and pressure on the real.

The logic for most countries issuing foreign currency debt is to extend their maturity by issuing at horizons over which there is no demand for local-currency-denominated debt. In my view, debt managers in Brazil should limit the use of exchange-rate-indexed instruments for this purpose, and allow the private sector to provide hedge.

Some progress has been made in reducing the outstanding stock of floating-rate debt, as it now represents about 50 percent of total debt (down from 57 percent in 1999). However, recent events have once again highlighted the risks of such a short-term maturity profile. Brazil should seek a further extension of its maturity profile. As it is, its average maturity is 32 months. This is a big improvement from the 12 months registered in 1999, but it still pales in comparison to some other emerging-market countries. A prudent liability management strategy would seek to extend Brazil's maturity structure even more sharply than already achieved, and de-link debt from the overnight interest rate.

Finally, it should come as no surprise that I concur with the authorities' objective for fiscal policy to ensure stability in the public debt dynamics. It is clear that fiscal consolidation will have to focus on expenditure restraint, and I join the staff in urging the authorities to reduce the practice of revenue earmarking, and to work to reduce expenditure rigidities. Further expenditure reductions, if required, should be as friendly to medium-term productivity as possible, and thus should probably focus on current outlays, while sparing those capital expenditures that enhance longer-term productivity.

Mr. Barro Chambrier submitted the following statement:

Despite an increasingly difficult environment, the Brazilian authorities have steadfastly pursued their economic and financial program of adjustment. Faced with a worsening external situation and a severe energy crisis, the authorities have moved swiftly to adjust their macroeconomic policy stance and to take other policy measures, which have enabled the country to withstand these shocks, and to meet the performance criteria and indicative targets of the program for the period under consideration. I commend the Brazilian authorities for their skilful and prudent management of the economy and for the progress achieved, which are also indicative of their commitment to the program for which they have demonstrated a keen sense of ownership, as Mr. Portugal reminds us in his informative statement. However, reflecting the exogenous external and domestic developments, economic activity has slowed down significantly and the real has come under pressure. To ensure the achievement of the medium term objectives of sustained economic growth and to bring down the debt to GDP ratio, the program needs to be strengthened. I, therefore, welcome the approach taken by the authorities in canceling the existing Stand-By Arrangement, and to replace it by a new one, which addresses the new challenges. I am in broad agreement with the objectives and policy measures envisaged under the new program and I can support the authorities' request.

Maintaining consumer and investor confidence is of critical importance, and in this context, the authorities need to focus on measures that will show clearly that they are serious about reducing the debt-to-GDP ratio, and to maintain financial stability in the context of low inflation. Therefore, they will have to pursue steadfastly their skillful conduct of macroeconomic policies and maintain a firm commitment to structural and institutional reforms. However, given the policy of inflation targeting that is being pursued, further fiscal consolidation efforts take on added importance. In this context, I welcome the new primary surplus objective that is envisaged. Although this approach may adversely affect economic activity in the short run, the authorities will need to guard against any counter cyclical policies, which could make the financial position more difficult.

However, I note that the room for maneuver in the fiscal area is rather limited. As the staff pointed out, there is a certain rigidity in government spending in Brazil, as a large volume of primary expenditure is dedicated to personnel or tied to earmarked revenues. Moreover, as the revenue-to-GDP ratio is already high, the program does not envisage any new revenue measures. The projected increase in revenue in 2002 will come from the full year impact of the rise in the CPMF rate as well as some increase of income tax collections in relation to GDP. It also assumes a freeze in discretionary current spending in real terms as well as a reduction in capital expenditure. Given the prospects of a more pronounced slowdown in the world economy, and the higher social expenditure and energy-related outlays, achieving the fiscal target in the present context does not seem to be easy. Nevertheless, I note that on the fiscal issue, in the recent past, as Mr. Portugal points out in his statement, the authorities have achieved or surpassed their objective. Furthermore, the progress made under the Fiscal Responsibility Law, as well as the strong commitment of the authorities to take additional measures, if necessary, give cause for optimism.

As regards monetary policy, while the inflation targeting framework has served the country well, it also appears that more recently the various shocks that have affected the economy, including the adjustments to administered prices have caused inflation to be higher than expected. The increase in the interest rate has been appropriate, and I broadly agree with monetary policy as outlined in the program. In the present context, it will be important that monetary stance remains tight, so as to keep inflation low and also in support of the exchange rate. However, the authorities' tasks will remain difficult. In view of the still high public debt, the impact of the higher rates on the debt will have to be balanced against the benefits of faster progress on the inflation front. On the issue of the public debt, I note that the debt-to-GDP ratio has not declined, and with a projected slowdown of economic activity, this ratio may even increase. Therefore, besides the macroeconomic measures being taken, the authorities will need to continue or even strengthen their efforts to seek a reduction in the shares of floating rate and foreign exchange indexed bonds. Efforts will also have to be pursued to try to increase the average maturity and duration of the debt stock.

On exchange rate policy, I welcome the authorities' commitment to the floating exchange rate regime and not to target any level of the exchange rate. The authorities have been following a pragmatic approach up to now that has enabled the exchange rate to absorb some of the impact of external shocks, and they need to maintain the same approach.

On structural reforms, while I welcome the overall progress made, I also note that progress in the first part of this year has been below expectations. I encourage the authorities to accelerate the envisaged reforms, in particular in the fiscal and financial areas. In the fiscal area, the reform of the pension funds and the introduction of the social security contribution by retired civil servants as well as the reform of indirect taxation have become more important in view of the rigidity in the fiscal area. Progress in these areas will increase fiscal flexibility, and will contribute to achieving the medium-term fiscal targets. There are other areas of taxation, as outlined in the Memorandum of Economic Policies, that need to be reviewed and we encourage the authorities to take the necessary steps to get the appropriate legislation to the congress, so as to improve the efficiency of the tax system.

Progress has also been achieved as regards the privatization program, especially in the areas of energy, telecommunications and financial services. But much remains to be done. As regards the energy crisis, I welcome both the demand- and supply-side measures taken by the authorities and which have contributed to a lessening of the adverse effects. However, many of those measures are of a short term nature and do not address the fundamental causes of shortages which appear to be partly related to the regulatory environment that discouraged private investment in the energy sector. I would therefore encourage the authorities to give more attention to improving the regulatory framework as well as allowing the private sector to play a larger role in energy production. As regards the three largest hydroelectric plants owned by the government, I note that their sale have been postponed due to the prevailing energy crisis. While I share the authorities' concerns as regards these sales in the present context, I would nevertheless encourage them to continue their efforts to improve the efficiency of these plants, so as to make them more attractive when the time comes for their sale.

In conclusion, there is no doubt that solid progress has been made over the past years in the stabilization of the Brazilian economy and in improving the efficiency of the economy and making it more resilient to shocks. However, as recognized by the authorities much remains to be done, and given the likelihood of a more difficult external environment, it is important that the authorities strengthen further their adjustment efforts. The present program for which Fund support is requested goes in the right direction. Nevertheless, due to the uncertainties, it will be important that the authorities remain ready to take on additional measures to achieve the medium-term objectives, and I wish them continued success in their efforts.

Ms. Kelkar submitted the following statement:

We thank the staff for a well-written report which, along with an exceedingly useful statement from Mr. Portugal, provide a comprehensive account of the progress made by Brazil under the current Stand-By

Arrangement and make out a convincing case for a replacement Stand-By Arrangement on the basis of a strengthened program. We are in broad agreement with the staff appraisal.

The Brazilian economy made commendable progress under the current three-year Stand-By Arrangement approved in December 1998. This is evident from Table 1, which shows that in 2000 all fiscal, monetary and external sector performance criteria or indicate targets were met and most structural benchmarks were compiled. The turnaround in fiscal situation—from a primary deficit of one percent of GDP in 1997 to a primary balance of 3.5 percent of GDP in 2000—is indeed sympathetic of the strong progress achieved.

This remarkable performance emanated from prudent macroeconomic and structural policies which included, enhancement of the Fiscal Responsibility Law that established a sound framework for the public finances; skilful debt management leading to an improved debt profile, despite the deterioration in financial conditions; successful implementation of an impressive privatization program yielding US$82 billion; full fledged restructuring of the financial system; and, deepening of trade liberalization through a substantial reduction of import tariffs and elimination of all non-tariff barriers.

Of late, however, the Brazil economy has slowed down especially in the second quarter of 2001 as a result of the global slowdown, financial contagion from Argentina and a domestic energy crisis. These unfavorable developments led to a substantial depreciation of the real, higher than projected inflation, widening bond spreads and a general weakening of market confidence, thus necessitating a strengthened program with augmented replacement of Stand-By Arrangement.

Our chair is broadly in agreement with the strengthened program. Mr. Portugal in his statement has pointed out that the government has already announced a number of initiatives so as to strengthen balance of payments. We welcome the authorities' commitment to tighten the fiscal policy further, with the targets for primary balance raised for 2001 and 2002. We hope that this will keep the debt dynamics under control and put the debt/GDP ratio on the much-needed downward trend in the medium term. Like Mr. Shaalan, however, we are also concerned that the underlying adjustment on the expenditure side in 2002 is concentrated on capital outlays, which may undermine growth impulses. On the monetary policy side, we welcome the tightening by raising interest rates by a cumulative 375 basis points since March 2001. This policy response was appropriate in view of the higher-than-expected inflation rate engendered, inter alia, by a sharp depreciation of the real. We are happy to note that the program recognizes that the potential for intervention can play a role in preventing or limiting contagion from external shocks. The proposed lowering of the NIR floor from US$28 billion to US$20 billion provides, in our view, a reasonable level of policy flexibility to the Brazilian authorities.

The structural reform agenda has been appropriately focused on the fiscal and financial areas. We welcome the continued progress in the privatization program and the planned reforms to the system of indirect taxation, pension system, capital market supervision and laws governing bankruptcy and corporate governance. Our chair also welcomes the commitment of the Brazilian authorities to participate in the FSAP. The staff report provides a very helpful annexure on the energy crisis in Brazil (Annex I). We wish to commend the authorities for their innovative system of energy quotas aimed at minimizing the impact of the energy rationing on GDP. Have the Brazilian authorities considered the option of diversifying energy sources? Has nuclear energy been explored as a possible option? In this regard, we feel that French experience has much to commend.

Our chair feels that the staff report and the Board discussion should offer an unambiguously positive signal regarding the quality of the strengthened program and the ability of the Brazilian authorities to implement it. With these comments, we support the proposed decision and wish the Brazilian authorities every success in their policy endeavor.

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

The Brazilian authorities have requested the cancellation of the existing Stand-By Arrangement and have proposed a new 15-month program with augmentation of access up to more than SDR 12 billion (400 percent of quota). In light of the significant progress in reform implementation in recent years, and taking into account the developments in Argentina as well as the situation in the energy sector in Brazil, we support the proposed decision.

It is hardly possible to question the Brazilian authorities' achievements in economic policy conduct in the period after the devaluation of the real. They have put in place the credible inflation targeting framework, improved debt management practices, made a leap forward in transparency, and advanced structural reforms. At the same time, it would be fair to say that current difficulties in Brazil stem not only from exogenous factors, but also from the authorities' insufficient efforts to address the weaknesses in the fiscal area. On the occasions of the previous reviews of the program, many Board members called for more ambitious efforts in the fiscal area and warned that Brazil may be forced to introduce the pro-cyclical measures if the economic environment were to become less favorable. This is exactly what is happening this year, when the sequence of events and developments have made pro-cyclical fiscal and monetary policies unavoidable.

The baseline scenario discussed by this Board last March turned out to be overly optimistic. Under this baseline scenario Brazil was expected to achieve an overall fiscal deficit of 3.5 percent of GDP in 2001. Instead, it is likely to run a 6 percent deficit this year, and the marginal increase in the primary fiscal surplus from the projected 3 percent to 3.35 percent of GDP pales in comparison with the worsening of the overall deficit. We take note of the arguments advanced by Mr. Portugal in his comprehensive statement regarding the difficulties the country is facing and his conclusion that even a 0.35 percent of GDP increase in primary fiscal surplus would represent a major step forward. However, what the Brazilian authorities really need is not only to obtain additional financing from the Fund, but also to persuade the financial markets that Brazil's fiscal and debt situation is sustainable. We believe that the financial market participants pay much more attention to the level of overall fiscal deficit rather than to that of the primary fiscal balance. It is true that the latter was made the focus of the previous program, but this was related to the financial conditions immediately after the devaluation of the real when interest rates stayed at exorbitant levels. However, we believe that now, three years later, the focus on the primary fiscal deficit is rather questionable. It would be more appropriate to focus on the overall fiscal deficit and on the debt-to-GDP ratios. Disturbingly, there has been very little progress in these areas.

In the program adopted after the devaluation of the real, the net debt-to-GDP ratio was projected to decline gradually to the level of 44 percent of GDP. Under the March 2001 scenario the net debt-to-GDP ratio was projected to remain at the level of about 50 percent of GDP until 2005, and no reduction in the debt level was anticipated until then. At that time, several Board members had pointed out that such a scenario was in sharp contrast to the authorities' original intentions and plans. In the newly proposed program the anticipated debt dynamics are even less favorable, as the net total debt of the consolidated public sector is now projected to rise to 54.2 percent of GDP this year and then stabilize at that level until 2003. Of course, we know that this can partly be explained by larger than anticipated devaluation of the real, recent revisions to the GDP data, additional capitalization included in the debt. However, such debt dynamics increase the expectations of a deteriorating debt situation and raise questions about the adequacy of the authorities' fiscal policy response.

While under the previous program primary fiscal deficit targets had been observed, this happened under much more favorable growth performance than was anticipated under the program. In other words, although in 1999 and 2000 growth performance in Brazil turned out to be much more favorable, no corrections in the primary fiscal deficit targets had been made. This year, the output growth is projected to decline to only 2.2 percent and, in addition to 375 basis points increase in the SELIC rate, Brazil now has to embark on fiscal tightening. In our view, such pro-cyclical policies could have been avoided had the authorities introduced credible fiscal adjustment measures earlier. At the same time, even these most difficult pro-cyclical fiscal measures proposed under the new program may turn out to be not sufficient. We have an impression that the fiscal policy strategy under the new program is based mainly on quick improvements in the external conditions and on the extension of the distortionary financial transaction tax until 2004. It is also pointed out in the staff report that 2002 will be an election year and it would be unrealistic to expect additional fiscal tightening in Brazil. Perhaps, under such circumstances much more emphasis should be placed on more ambitious and faster structural changes in the fiscal area.

Another serious matter of concern in the Brazilian program is the apparent lack of redistribution of currency and interest rate risks. Despite the switch to a floating exchange rate regime, the government and the central bank are still playing the role of the counterpart in the hedging activities of the private sector. The result of this is the excessive sensitivity of the public debt and fiscal deficit to changes in the exchange rates and interest rates. At the same time, the banking system still operates under the conditions of perverse incentives: private banks have to worry about the possibility of interest rates reduction and of the currency appreciation, instead of concentrating their efforts on financial intermediation, on lowering spreads, and on financing viable projects. We hope that the upcoming FSAP exercise will be broad in its scope and frank in its recommendations.

We wish the authorities every success in their endeavors.

Mr. Mirakhor submitted the following statement:

We commend staff for a report of high quality and thank Mr. Portugal for his illuminating statement. Brazil’s performance under the three-year Stand-By Arrangement has been exemplary. Thanks to the sound framework provided by the Fiscal Responsibility Law, significant progress was made in strengthening the fiscal accounts at all levels of government. Output growth was positive, the transition to a floating exchange rate in the context of relative price stability was managed with great skill, and progress was made in moving forward with the government’s privatization agenda.

Unfortunately, these favorable developments have been undermined by a series of exogenous shocks—notably, a weakening of market confidence in the context of a deteriorating external environment and a domestic energy crisis. The authorities have responded to these shocks with a strengthened program of macroeconomic adjustment and reform that is impressive in scope and content. The program promises to restore growth and financial stability and help Brazil strengthen its resilience to a further external shock. Given the authorities’ track record of solid policy implementation, and the strength of their new program, we support the request for a new arrangement and the level of access being proposed.

Fiscal consolidation remains the cornerstone of Brazil's adjustment efforts and central to the urgent task of putting its debt dynamics on a more favorable path. The staff notes that the targets under the program are "ambitious but achievable" and we share this assessment. Given the already high revenue-to-GDP ratio, it is appropriate that the program concentrates on limiting expenditures while protecting social expenditures and increasing investment in infrastructure in response to the energy crisis. We agree with Mr. Portugal that this tightening of fiscal policy represents a "significant new effort" on the part of the authorities especially considering the relatively inflexible structure of public expenditures. We are pleased with the authorities continued commitment to implement additional reforms in the fiscal area, namely, seeking congressional approval for the remaining legislation on the reform of pension funds and moving forward of reforms of indirect taxation. We welcome the government's request for FAD technical assistance to help pave the way for reforms that enhance revenue efficiency.

Given the shocks experienced by the economy, monetary policy faces the challenging task of mitigating the pass-through effects of the recent exchange rate depreciation and administrative price adjustments. The response of the BCB to the build up of inflationary pressures has been appropriate and recent inflation performance noted in the staff supplement suggests that inflation is declining in line with the target for 2002. Nevertheless, as the authorities recognize, monetary policy will have to be kept tight, even at some cost to growth, and policy implemented in a preemptive, forward-looking manner. On exchange rate policy, we welcome the authorities continued commitment to a floating exchange rate regime, and to limited, preannounced, intervention with a view to providing liquidity to the market to smooth exchange rate pressures. Moreover, the program rightly provides for some additional scope for potential intervention should conditions warrant. As Mr. Portugal notes, this lowering of the NIR floor should positively influence expectations, as it would signal the authorities' preparedness to deal with "any major additional disruptions."

Despite a worsening of the global outlook and an increase in risk aversion towards emerging markets, Brazil's balance of payments situation and outlook appear to be manageable with, inter alia, FDI flows still accounting for a large portion of the current account deficit and access to markets remaining comfortable despite a widening of sovereign spreads. The country's frequent and constructive contacts with the international investor community and rating agencies, and its ability to quickly activate a new voluntary agreement with commercial banks for the maintenance of interbank and other trade-related credits, should be a continuing source of strength for the balance of payments.

In addition to the structural reforms in the fiscal area noted above, the authorities' plans for further reforms in the financial sector are far-reaching. We attach particular importance to the early passage of laws relating to the corporate sector, bankruptcy and insolvency, and the quality and transparency of accounting standards. We note the implementation of the comprehensive strategy to strengthen the federal banks, separate their commercial activities from directed lending to agriculture and housing, and the intention of recording the subsidies to these sectors transparently in the budget. The authorities continue to make progress with privatization and we are pleased to learn that they have requested participation in the FSAP program.

In conclusion, Brazil's strengthened program is an impressive demonstration of the authorities commitment to continued adjustment and reform in the face of emerging challenges. We agree with staff that the full implementation of the program will be required to meet program objectives. While risks remain, mainly in the context of an uncertain external environment, Brazil's record of strong and determined policy stance in facing crisis situations—and the authorities readiness to adjust policies further if conditions warrant—augurs well for the success of the program.

Mr. Usman submitted the following statement:

Brazil has made significant progress since the last review under the Stand-By Arrangement. The solid growth performance of 4.3 percent in the first quarter in 2001 was, however, significantly dampened by worsening global economic conditions, continued difficulties facing Argentina, and an increase in domestic interest rates to contain the depreciation of the real. Consequently, growth for the second quarter slowed down to 0.8 percent of GDP, and is now projected at 2.2 percent for 2001 as a whole, almost a half of the projected rate in the program.

The economic conditions were further exacerbated by weak seasonal rainfalls, which together with a regulatory framework that has not been conducive for private sector investment in the energy sector, added to a shortage of electricity supply. While we commend the authorities' efforts in successfully promoting electricity conservation; we would urge them to address the regulatory framework to facilitate future private sector participation in electricity generation.

The weakening of financial conditions in Argentina has had a direct impact on interest spreads of Brazilian bonds, with spreads widening by some 200 basis points; and has had an adverse effect on the real. The resulting depreciation of the real prompted the Brazilian authorities to adopt an intervention framework to smooth the movement of the currency. The depreciation of the currency has also had a negative impact on inflation, and the authorities increased interest rates to arrest the decline of the currency and to contain inflationary pressures. Notwithstanding the current financial difficulties, we would urge the authorities to continue their current approach of allowing market forces to determine the value of the real vis-à-vis other currencies.

Although in line with the program expectations, the current account also weakened during the period under review. This was caused mainly by a weaker trade balance, notwithstanding growth in exports. We are pleased to note staff's estimation that the trade balance is likely to improve over the medium-term, which would also result in a narrowing of the current account in relation to GDP, as exports start to benefit from the weaker currency. We are also pleased to note that the current account deficit for the 2001, is largely covered by expected inflows of FDI, with the latter indicating that foreign investors are continuing to hold a positive view of the Brazil's very substantial economic potential.

Notwithstanding the softening of financial conditions, Brazil has continued to enjoy relatively uninterrupted access to international capital markets. The authorities have successfully floated foreign bonds this year, well beyond their financing and amortization needs. We are also pleased to note that Brazil's level of foreign reserves is currently beyond targets, and we commend the authorities for steadfastly continuing to pursue improvements in the structure and management of their debt portfolio and debt dynamics. Furthermore we welcome the authorities' intention to participate in the FSAP of Bank and Fund and the Fund's fiscal transparency module ROSC, following the assessment of the observance of the Basel core principles. In addition, we welcome the intention of the authorities to progressively improve compliance with internationally accepted accounting standards.

Despite Brazil's favorable short-term financial position, however, the country's medium term outlook appears vulnerable in the face of global conditions in general, and the Argentine situation in particular. We believe it is in this connection that Brazil has approached the Fund for a new 15-month Stand-By Arrangement, and cancellation of the current 3-year Stand-By Arrangement to enable the authorities to address potential financial difficulties that may arise in the prevailing uncertain global environment. We have no hesitation in supporting this request, given Brazil's exemplary performance under the current arrangement.

We wish the authorities success with their future endeavors.

Mr. Djojosubroto submitted the following statement:

At the outset, we would like to thank staff for a well written report and Mr. Portugal for his very helpful statement. We note that, generally, Brazilian authorities have once again continued to steer the economy in the right direction. The performance of conditionalities under the current Stand- By Arrangement has been largely on track. However, the recent adverse international economic development, especially in Argentina, and the domestic energy crisis due to drought have greatly undermined the economic situation in Brazil. The real has lost its value by about one-fourth and bond spread widened by about 200 basis point since January. This has forced the authorities to adjust upward their administered prices. As a result, the inflation in the past few months have increased higher than expected and will less likely achieve the officially targeted 6 percent of its upper limit for end-2001, and the economic growth is estimated to slow down to about 2.2 percent for the whole year.

Regarding the quasi-fiscal policy and federal banks restructuring program, we welcome the steps taken by the authorities to resolve the status of a major contingent fiscal liability arising from the transactions of four federally-owned commercial banks. However, given the financial complexity and poor track record in governance and transparency of those banks, we wonder what is going to be the roadmap and milestone to measure the progress of the restructuring program, its sequencing and its priority. Staff comments are welcome. We urge the authorities to be firm and consistent in its actual implementation, keeping its objectives in mind all the time. Good judgment should also play a critical role in this process.

We note that Brazil's inflation targeting framework has, so far, been working well. We welcome the drafting of legislation in the financial sector, whose purposes is to improve capital market supervision and to enhance the autonomy of the Brazilian Central Bank. We are encouraged by the authorities' firm commitment to accelerate the passage of these laws. However, in case there might be some delay in the process of adopting those laws, it would be helpful if the authorities have prepared a second plan to persevere with Congress in order to have them passed as soon as possible in tandem with the momentum of the restructuring program. The government's approach to gradually adopt internationally-accepted accounting standards is a step in the right direction and we welcome the government's intention to participate in the Financial Sector Assessment Program.

With these remarks, we support the authorities' request for a new Stand-By Arrangement and wish the authorities every success in their endeavors.

Mr. Zoccali and Ms. Ocampos submitted the following statement:

We would like to commend staff for a well-written report on Brazil and Mr. Portugal for his substantive statement. Both highlight the success of the current Stand-By Arrangement predicated on the strong commitment and ownership of the authorities to meet the performance criteria and objectives under the program. The authorities deserve commendation for the skillful management of the economy amid volatile regional conditions, an energy crisis, political uncertainties and last but not least a marked and self-reinforcing slowdown in the world economy. In this context, we fully support Brazil's exceptional precautionary access under a replacement Stand-By Arrangement for a period of 15 months until the end of the government's mandate in December 2002.

In the circumstances just described, favorable performance of the Brazilian economy through the first quarter of 2001 gave way to a pronounced slowdown in economic growth, a significant depreciation of the real and a general weakening of market confidence. The authorities responded forcefully by increasing the overnight interest rate (SELIC) aimed at containing inflationary pressures associated with the strong exchange rate depreciation, maintained the fiscal stance and implemented a drastic energy saving plan to restrain demand. The flare up in inflation and the higher than programmed increase of debt to GDP ratio were limited as a result of the better than programmed primary fiscal surplus of the consolidated public sector, as well as significant advances in ongoing structural reforms.

We agree with the authorities and staff on the importance of fiscal policy to underpin Brazil's macroeconomic stability given the floating exchange rate regime and the need to establish the credibility of the inflation targeting framework. The strengthening the structural reform effort would afford the needed degrees of freedom to improve the public debt dynamics and deal more effectively with external shocks.

Monetary policy in Brazil has the difficult task of reconciling an open capital account with market concerns regarding the public debt dynamics. Intervention in the exchange market in conjunction with gradual hikes in the SELIC rate has been the appropriate response shoring up the beleaguered currency and staving off inflationary pressures. In this context, we welcome the lowering of the NIR floor in the program to provide needed flexibility to authorities to avoid major disruptions caused by a sudden deterioration of market sentiment and the importance of containing the spill over effect of the currency depreciation in the region. Greater predictability in exchange rate movements could serve to lower the public sector financing requirement while fostering more stable trade relationship. As importantly, given Brazil's relative size greater exchange rate stability would provide self-reinforcing incentive to avoid more general resort to competitive currency depreciations which, in turn, undermine the long-term macroeconomic prospects in the region.

Since the beginning of the 90s Brazil and a majority of Latin American countries, have adopted profound trade liberalization policies leading to a substantial reduction in the average level and disperse of import tariffs, as underscored by Mr. Portugal. In this vein, we encourage the authorities to continue with their efforts and the reduction in particular of non-tariff protection still affecting a broad range of tradable goods.

The authorities deserve commendation for their fiscal consolidation effort, exceeding expectations even in very unfavorable circumstances. The challenges in 2002 are equally daunting given the rigidity of current expenditure and the difficulty of relying on further increases in the tax burden. Accordingly, we concur on the importance of reducing earmarked revenues and current expenditure and move forward on structural fiscal reforms underway such as of the tax system to reduce the incidence of distortionary taxation.

We welcome the authorities´ commitment to reduce the level of outstanding public debt that remains extremely sensitive to changes in nominal interest and exchange rates. The efforts noted by Mr. Portugal to increase the average maturity of the outstanding debt stock are to be encouraged and the transparency gained in the public debt management will contribute to this objective.

The sustainability of the fiscal consolidation and disinflation effort requires continued strong progress in implementation of the authorities' structural reform agenda. In this regard, we welcome the comprehensive restructuring of four major federal banks and the decision to budget the quasi-fiscal deficits stemming from subsidized operations. The resulting increase in public sector indebtedness, by about 1 per cent of GDP is fully justified but should be carefully monitored to contain moral hazard. In this context, the parallel measures to improve governance are seen as the linchpin for the successful restructuring effort.

With these comments we wish the Brazilian authorities continued success in their adjustment endeavors.

Mr. Wijnholds submitted the following statement:

I welcome the contingency nature of Brazil's request in the face of a distinctly adverse external environment. Given the signaling role of this program and its stated objective to restore confidence, I am surprised, however, that the authorities have apparently indicated that they do not wish to publish the document.

Let me start with a few general observations and then provide a few specific remarks on the program.

The first observation I have is that the announcement of Brazil's program has had very little impact on the market. On August 3, when the Fund issued a press release for the $15 billion in new IMF financing, Brazil's EMBI spread was 958 basis points over U.S. Treasuries. Since then, the spread has risen instead of declined (as we would have expected) and on Monday stood at 973 bps. In addition, the correlation between Argentine and Brazilian spreads has remained above 0.9 percent.

This once again shows that money alone does little to improve market confidence. And it also underscores perhaps the market's assessment of Brazil's vulnerability. Indeed, looking at the vulnerability indicators presented in the report I have to say that—despite strong implementation under the Fund arrangement—Brazil still has a substantial road ahead of it in reducing its dependence on external financing. A few facts that caught my eye in the paper. First, even after allowing for the roughly $20 billion in foreign direct investment, Brazil still has an external financing requirement of roughly $60 billion. Second, the reserves- to- short-term external debt ratio (residual maturity) still stands at a uncomfortably low level of roughly 65 percent. Moreover, this ratio does not really improve until after 2003, while gross reserve levels under the program in fact show a small decline. Also, external debt is lower in terms of both GDP and exports than in neighboring Argentina but by no means has it entered the sustainability comfort zone yet. Debt service still takes up close to 70 percent of annual export earnings. A final vulnerability I will mention is the persistently high current account deficit of 5 percent of GDP, despite the very substantial depreciation in recent years (15 percent in real effective terms this year). The fact that Brazil has to transfer roughly 4.5 percent annually in interest payments and profit transfers, of course requires it to run trade surpluses.

My second set of comments relates to debt sustainability. I welcome the analysis in the report, including the sensitivity analysis. I agree with staff that the predominance of floating rate and exchange rate-indexed securities have substantially complicated the debt dynamics. It is also noteworthy that if GDP growth is only 1 percent below the baseline, Brazil will see its debt/GDP ratio jump by 3.5 percentage points rather than fall. Staff suggests that this underlines the need to react vigilantly to setbacks. However, I would argue that this in fact underscores the need for targeting higher primary surpluses. As things stand, Brazil has very little buffer to speak of.

Let me elaborate briefly on Brazil's debt management. I acknowledge that Brazil is walking a bit of a tightrope, balancing debt dynamics with an immediate need to deal with rollover risk. However, it is disappointing that the share of floating rate debt and exchange rate linked debt is virtually unchanged from 1999. In my view, the instability of the debt dynamics are responsible for a large part of Brazil's risk premium in financial markets. Thus, I would urge to reduce the vulnerabilities in Brazil's debt structure. It is particularly disappointing that Brazil seems to have been unable to reduce in any way the amount of exchange rate linked debt. In fact this has even increased from roughly 23 percent of the total a few years ago to roughly 27 percent now. And here I would like to reiterate something that I have said in the past: issuing exchange rate linked debt is akin to intervening in the foreign exchange market. That is, the government by issuing this debt meets private demand for a foreign exchange rate hedge (equivalent to selling a domestic currency bond and an NDF contract simultaneously). In this regard, the staff report's statement that foreign exchange intervention is limited to the roughly $6 billion that is scheduled is not entirely accurate. By issuing exchange rate linked debt, Brazil has this year covered an additional $16 billion of exchange rate risk for private individuals (this can be deduced from table 15). These are contingent liabilities that continue to add to Brazil's debt stock, and I hope that staff will take a firm stance in trying to reduce this type of issuance.

I would welcome a comment from staff on whether they deem the current exchange rate levels undervalued and by how much. Brazil is obviously in a predicament, balancing the costs of further depreciation on higher inflation and adverse debt dynamics against the benefits. It would seem a priority to protect the inflation-targeting framework, but the exchange rate obviously has economy-wide repercussions. At the same time, real interest rates are also still very high and seem to be choking off export growth. I would thus welcome some remarks on what Brazil's options really are at this juncture, and whether there is a critical level of the exchange rate where we would have to change strategy.

Two final comments on fiscal policy. It is not clear, how extending the financial transactions tax by 2 years puts the fiscal consolidation on a sustainable footing, as noted on page 15. Financial transactions taxes are generally seen as regressive and inefficient, although they do generate substantial revenues. They are, however, "second-best" and I would ask staff to assess whether less distortionary alternative measures are possible moving forward. And finally, as a more general remark, the staff report seems to contain a paradox. It is noted on one hand that discretionary spending amounts to only 15 percent of total primary federal spending. On the other hand, however, the report notes that the fiscal effort concentrates on controlling expenditure relative to GDP, while protecting social expenditure and increasing infrastructure and energy spending. How all these aims are supposed to be achieved simultaneously remains a puzzle to me. One issue, which is adding to this rigidity in fiscal finances, is the large degree of earmarking. I am in full agreement with staff that earmarking needs to be reduced.

This brings me to my final comment. The banking sector is clearly still of concern as described for instance in paragraph 15 of the report, although the main concerns relate perhaps to the public banks. Staff's assessment in this area is confirmed by a recent internal BIS assessment, which ranks emerging markets in a banking sector vulnerability index. On a scale of 1-10, with 10 being the most vulnerable, Brazil still ranks a 7 according to the BIS (this ranking dates back to end-2000). This is the same as Indonesia and Mexico, better than Turkey and Russia (both with an 8), but worse than most other Latin American countries (Chile, Colombia, Peru, Venezuela and even Argentina although that may now be outdated). In this regard, I very much welcome Brazil's participation in the FSAP and also the fact that the list of structural benchmarks focuses on the banking sector.

With these remarks, I wish Brazil the best of luck in continuing its successful performance under Fund programs.

Mr. Törnqvist made the following statement:

The program for Brazil appears to be well-designed, with an appropriate emphasis on fiscal adjustment, structural fiscal measures, and financial issues. It also appears to be based on realistic macroeconomic assumptions, although the program is quite ambitious, given the procyclical implications of the fiscal effort under the current conditions.

However, the Brazilian authorities' commitment under the current program and the sensible policy reaction to adverse external events have been very encouraging. For these reasons, and given the authorities' intention to treat the program as precautionary, I believe the request for this program is well warranted and I support the proposed decision.

I would like to commend the Brazilians authorities for their performance under the current program, in particular the fiscal performance has been impressive and better than programmed, not only at the central governmental level, but also at the state and local level.

It seems like the passage of the Fiscal Responsibility Law has provided the necessary institutional framework for a prudent fiscal policy. In addition, progress has been made on the structural agenda.

Despite the strong program implementation, developments since the 7th review in March have illustrated that Brazil is still vulnerable to unfavorable external economic developments and, I might add, to unfavorable weather conditions. This has been reflected in the sharp reduction of the value of the real and the widening of bond spreads.

In order to combat inflation, it has been necessary to tighten monetary policy significantly. All these developments have led to a sharp deceleration of the growth rate. The procyclical nature of the fiscal adjustment under the program is likely to exacerbate this trend. However, the last inflation figure is somewhat encouraging.

Despite the overall impressive fiscal performance, the debt-to-GDP ratio has increased as a result of the weakening exchange rate, increased interest rates and reduced growth. It is unfortunate that the program performance in this respect has been weak since debt remains a source of vulnerability, given the already high debt-to-GDP ratio and the persistently wide current account deficit. The government has taken important steps to counter these developments by adopting more ambitious fiscal targets. The increase in the public debt ratio has been partly due to the structure of public debt, which, to a large extent, its exchange rate is linked to short-term interest rates. A change toward more long-term borrowing would decrease vulnerability on this front. The experience so far suggests that reducing the debt to a more sustainable level may take some time, especially with the unusual debt dynamics, where lengthening the debt profile runs counter to reducing the debt-to-GDP ratio. We recognize that there is no easy solution in this situation, and appreciate the efforts in debt management and investor relations that the authorities have undertaken as described in Boxes 2 and 4.

On monetary and exchange rate policy, the authorities are facing a dilemma, as noted by Mr. Wijnholds. However, I do not think that foreign exchange intervention is the right solution. And, I fully agree with Mr. Bernes's comments on the authorities' intervention policies and, like him, I believe that these resources would be better used to pay down debt. In view of the comments made by the staff today, I would like to know what actually would constitute the exceptional circumstances that allow exchange rate interventions above the stated limits.

The current account deficit has remained surprisingly wide at about 4 percent of GDP, despite the sharp depreciation of the real. Even though it has to a large extent been financed through foreign direct investment, it still contributes to vulnerability, especially in case of a global economic slowdown. This unrelenting deficit indicates that Brazil has some way to go in terms of improving its export performance and competitiveness.

As I have indicated on previous occasions, this chair does not view the financial transaction tax as an appropriate policy measure. Experience from our constituency has proved that such taxes are distortionary and inefficient. Like Mr. Wijnholds, I find the statement by staff unfortunate that prolonging this tax will put fiscal consolidation on a sustained footing. In this context, I would like to ask staff or Mr. Portugal whether alternatives to this measure have been contemplated.

On the subject of promoting good policies, I note from Box 1 in the report that revenue earmarking still plays a significant role and wonder if more could be done under the program to reduce this practice.

The energy crisis is an unfortunate complication, but I would note that it has not entirely been caused by poor rainfall. As in other countries, some of the blame can be attributed to insufficient planning. We would support the staff in their recommendations that it would be critical for the authorities to carefully implement their program to increase the energy supply.

Finally, like others, I welcome the effort to strengthen the position of the federal government, commercial banks, and the structural measures aimed at improving the financial sector. I especially welcome the authorities' decision to participate in a FSAP. The staff report indicates that the banking system is generally sound, with the exception of the public-owned institutions, which are a cause of concern. And, faced with an economic slowdown and increased external vulnerabilities, a checkup of the financial system is certainly warranted.

Like other Directors, I urge the authorities to reconsider the decision about the publication of the staff report.

Mr. Quarles made the following statement:

Under its existing program, Brazil has strengthened its policy framework and performed well in a difficult and changing external and domestic environment. The authorities have demonstrated political resolve to meet program targets. But due to increasing external uncertainties and lagging confidence, Brazil finds itself facing significant short-term financing pressures. Under these circumstances, we support a follow-on 15-month Stand-By Arrangement, largely on SRF terms, and welcome its precautionary nature. We generally share the staff’s and the authorities’ optimism that the proposed program, if pursued diligently, will make a positive contribution to sustained growth in and improved market sentiment toward Brazil. We also welcome the authorities’ commitment to consulting with the staff in the design of economic policies.

We nonetheless remain concerned about the potential for public debt to become increasingly burdensome because foreign-currency indexed and floating rate debt comprise a significant part of the debt stock. We also think the markets share this concern as evidenced by the muted reaction to management’s announcement of the program. In our review of policy options available to the Brazilian authorities, we cannot help but conclude that the answer lies with fiscal and structural measures, beyond what is contemplated in the program.

The proposed fiscal tightening is commendable. A tighter fiscal stance will give monetary authorities greater scope to reduce the high real interest rates, leading to a macroeconomic policy more supportive of long-term growth. We are concerned, however, that the proposed fiscal actions by themselves could be insufficient to fully safeguard public debt sustainability.

On the revenue side, we note Brazil plans to extend the "CPMF" financial transactions from mid-2002 to mid-2004. Though the revenue from this tax is critical, it is equally clear that this tax is distortionary. We encourage the authorities to seek alternative revenue sources even before the proposed 2004 expiration of this tax.

On the expenditure side, the program's objective to stabilize and reduce the burden of government debt may not be achieved even if all performance criteria are met. We urge the staff and the authorities to consider strengthening the program by incorporating measures to introduce greater flexibility into public expenditure on the grounds that flexibility may generate greater market confidence in the program's success.

The current monetary policy framework has been broadly successful in controlling inflation and maintaining economic stability, and remains appropriate for Brazil. However, we note that the recent failure to meet inflation targets and the expectation among analysts that the authorities will not meet their 2002 inflation target are threatening the authorities' credibility. We urge the authorities not to use the increased flexibility allowed by a lower NIR floor to resist market-led movements in the exchange rate or raise expectations that they are targeting the exchange rate. Such actions would further undermine the credibility of their inflation targeting framework.

We also think the program would have been stronger if dollar-indexed debt was frozen at current levels. These instruments are close substitutes for intervention in the spot market, and ceteris paribus, will lead to pressure on either the exchange rate or international reserves at their expiration. They also serve to undermine confidence in the sustainability of public debt.

On structural measures, we note that progress has been made under the current program, but it has lagged behind fiscal and monetary policy actions. Ultimately, the durability to withstand shocks and sustain higher rates of real growth will only come from broader structural changes in the Brazilian economy. For this reason, we urge the authorities to pursue structural reform measures both inside and outside the Fund-supported program. In particular, we believe obtaining quick passage of remaining legislation in the reform of pension funds is important. This would send another signal of the authorities' commitment to prudent fiscal policies. We also feel that a more aggressive approach to opening up Brazil's markets is essential.

We are pleased to learn that informal consultations occurred between Fund and Bank staff assessing linkages between environmental and adjustment conditions, even though such linkages were not mentioned in the Stand-By Arrangement document. In this regard, we hope that Fund and Bank staff will collaborate as needed to ensure that financial sector reforms discourage future lending for activities that are both financially and ecologically unsustainable.

Finally, we welcome the authorities' recent progress in restructuring federal banks, plans for further privatization of federalized state banks, and enhancing the regulatory framework and off-site bank supervision. We also welcome the government's intention to participate in the FSAP review. However, we were disappointed to read that the authorities do not intend to publish the staff report. Publication would complement Brazil's efforts to increase transparency and would provide the authorities with another way to communicate to interested parties the government's commitment to pursue appropriate economic policies geared to sustainable economic growth and poverty reduction.

Mr. von Kleist made the following statement:

As a result of important policy adjustments, particularly in the fiscal area, the resilience of the Brazilian economy has improved in the aftermath of the 1999 exchange rate crisis. Also, the shift in the exchange rate regime has, on the whole, been a success story, considering the robust recovery of growth and the only limited pick-up in inflation in the last two and a half years.

More recently, the relatively new policy framework is being tested by adverse developments that are only partly under the authorities' control. Clearly, as a first line of defense, it is critical that both macroeconomic and structural policies firmly stay their course, in order to generate much needed confidence in financial markets. We generally support the program agreed to this end. As others have noted, it will be a difficult one to implement, given the procyclical nature of the agreed policies and the upcoming elections in 2002.

We support the proposed decisions. I shall limit my further comments on this issue and on fiscal and monetary and exchange rate policies:

Firstly, on public debt management, we share staff's and other speakers' concerns about the difficult debt dynamics associated with the renewed rise in exchange rate-indexed public debt and the still high level of floating-rate debt. We note that even in the two years preceding the recent rise in uncertainty, the share of exchange rate-indexed debt was brought down only marginally and we encourage the authorities to reinforce their efforts to do so once market conditions allow.

Secondly, we welcome the increase in the near- to medium-term targets of government primary surpluses. However, the public borrowing requirement is nevertheless expected to rise substantially in 2001. The revised fiscal targets should therefore be adhered to, even if this may be challenging due to the rigidity of public spending and the relatively high GDP-ratio of revenues. Some of the measures envisaged for the remainder of this and next year are of an ad-hoc nature and little specified in the report—for example, the $1 billion real cut, the increase in the income tax-to-GDP ratio or the freezing of discretionary real current spending. These measures, as well as the prospective decline of non-energy related capital spending in 2001 by almost 20 percent, are not the kind of measures that can easily be repeated over an over. They thus highlight the urgency of ongoing initiatives, such as the complementary pension fund for civil servants and the taxation of civil servants' pensions, which will put the public finances on a longer-term sustainable footing.

On monetary and exchange rate policies, a couple of points: We support the firm monetary policy stance to avoid any second round and pass-through effects from changes in administered prices and the exchange rate, while at the same time keeping the focus on the medium-term inflation target. However, like others, we have some doubts as to the merits of the recently-announced policy of limited daily foreign exchange interventions. It seems likely that such interventions on a continuous basis are at least partly factored into the decisions of market participants, thereby reducing their effectiveness in reducing exchange rate volatility. Furthermore, such interventions are not entirely consistent with the inflation targeting framework and thus risk undermining its transparency. In addition, the magnitude of the pass-through of exchange rate depreciations is debatable and is estimated by some private analysts to account for no more than 10 percent of increases in the price level. This would further call into question the need of exchange rate interventions for the sake of supporting monetary policy.

On another point related to the inflation targeting framework: while I support the program's consultation mechanism in principle, I must confess I do not find the system of midpoints and trigger points entirely easy to understand. I wonder whether the parallel existence of the consultation bands and the inflation target itself as well as the fact that the consultation bands are being moved while the inflation target is left unchanged might undermine the objective of transparent communication of the inflation strategy.

On the proposed terms of the Fund credit, we have some concerns regarding its volume and its strong front-loading. If the resources were fully drawn upon, Brazil's outstanding IMF loans would reach about 15 percent of federal revenues and public external debt, respectively. Furthermore, about 30 percent of the funds are proposed to be available upfront. Now, I understand that the authorities intend to treat the arrangement as precautionary, although this is not brought out very clearly in the staff report. But this in itself raises some questions: The arrangement would, to my knowledge, be the first SRF-arrangement that is precautionary. I am not sure whether this is fully consistent with the purpose of the SRF, which was intended as a crisis facility rather than a preventive one.

Accidentally, Mr. Portugal states that Brazil's access to international capital markets remains comfortable. Would not a better option have been a smaller arrangement which—in the case of loss of market confidence—could have been augmented reasonably fast through the Emergency Financing Mechanism? Staff's comments would be welcome.

Coming back to the size of the proposed arrangement: Since there is no immediate financing gap for the time being, we have no firm basis for determining the appropriate size of the arrangement. Finally, I would be hesitant to lower the NIR-target, if that means that the authorities could under adverse circumstances use Fund resources to intervene in quite substantial amounts to defend the exchange rate.

Mr. Jonas made the following statement:

Overall, the authorities have done a commendable job under their previous program, and we support their request for the Stand-By Arrangement. Under normal circumstances, their policies would have sufficed to ensure not only financial stability but also rapid growth. But unfortunately, the external environment was not very helpful, and the negative supply shock caused by the energy crisis complicated the situation further. Therefore the authorities will have to redouble their efforts to keep inflation under control, and to cap and reverse growing public debt.

Let me comment first on monetary policy. The Banco Central de Brazil (BCB) faced a difficult situation when growth began to slow while inflation picked up. I think the central bank did a very good job. The rapid increase in interest rates was appropriate, and though it somewhat slowed the economy, the latest inflation data show that the BCB succeeded in bringing it under control. But it is still too soon to start reducing interest rates. Recently the currency has been quite weak, and some further inflationary effects may still be lurking in the pipeline, though probably less than the 6 or 7 percentage points above underlying inflation rate, suggested by Mr. Bernes. Moreover, in view of recent events, we should expect the real to remain under pressure for some time and I think that caution is not misplaced. Under these circumstances it would even be appropriate for the authorities to allow some further depreciation to take place, since resisting it could be quite difficult. Like other Directors, I think further large interventions in the foreign exchange market could cause a large decline in reserves, which could be counterproductive. Instead of strengthening the currency, it could weaken market confidence and the currency with it.

Despite the increase in interest rates and falling inflation, the BCB will probably miss its inflation target at the end of 2001, and there are some doubts about the 2002 target as well. But given the size of the external shocks, this should not damage the BCB's credibility, and the authorities should be able to give the public a credible explanation of the reasons for missing the target. Mr. Yagi and Mr. Toyama speak about the dilemma of choosing between inflation targeting and the floating exchange rate regime, but I do not see a real dilemma here. If the authorities stick to their inflation target and adjust monetary policy accordingly, I cannot imagine that the depreciation of the exchange rate could be large enough and last long enough to result in repeated large misses of inflation targets.

In the area of fiscal policy, the situation is more complex. Recent developments have again shown how sensitive public sector debt is to adverse market sentiment, increased interest rates, and currency depreciation. To illustrate, in March 1999, the program projected that net public debt would decline to 37.5 percent of GDP in 2003, but now we are looking at a net public debt of around 54 percent of GDP. This is a worrisome increase, and something needs to be done about it. Like Mr. Quarles, I think the authorities may need to make a stronger fiscal adjustment than foreseen under the arrangement. There were significant increases in the overall fiscal deficit and the public sector financing requirement, and the adjustment to the primary balance was relatively minor.

How might such an adjustment be accomplished? It is true that if and when the situation in the financial markets improves, the currency depreciation is partly reversed, and interest rates are lowered, all would assist the adjustment. But I am afraid that the improvement in market sentiment will not happen until the authorities take credible measures to further strengthen the primary fiscal balance and improve the debt dynamics. The very best option would be to increase fiscal policy's flexibility on the expenditure side. But I wonder if it is appropriate to abandon revenue measures altogether as long as there is only limited room for further reducing expenditures.

One final point. The staff explains that Brazil's financial indicators have been significantly affected by developments in Argentina. We should keep in mind that it is not just geographic proximity that made Brazil vulnerable to events in Argentina. Brazil and Argentina suffer from similar external weaknesses, resulting from the combination of low trade flows and large stocks of external debt. Brazil's external vulnerability indicators are not as bad as Argentina's, but are still bad enough. For example, about two-thirds of Brazil's export revenues are absorbed by external debt service. Like Argentina, Brazil must deal with this problem by opening its economy and reducing its vulnerability to changes in its access to external financing. Mr. Yagi and Mr. Toyama have made the very important point that Brazil and Argentina must avoid policies that might operate at cross-purposes. I think that in the future, the staff should more closely scrutinize this regional aspect of surveillance. We have provided two very large arrangements to two neighboring countries with close trade and financial links, and it is therefore very important to ensure that the policies we support in each work toward the same objectives, not only for the two countries themselves but for the Mercosur area more generally.

Mr. Padoan made the following statement:

Let me start by thanking staff for an impressive report and Mr. Portugal for a very comprehensive statement.

Brazil has shown very encouraging results in pursuing the objectives of the 3-year Stand-By Arrangement and its record in meeting the performance criteria and structural benchmarks under the arrangement has been highly satisfactory.

In view of this record, its continuing vulnerability to contagion effects, and the strength of its program, it deserves the continued support of the international community.

The request for a new Stand-By Arrangement as well as the proposed level of access (400 percent of quota) appear appropriate, in view of the need to maintain confidence against the background of a highly uncertain (and somewhat capricious, as Mr. Portugal puts it) international environment, and also to face the consequences of the severe energy crisis that has hit the country.

Also, the proposed split between GRA and SRF resources is consistent with last year's decisions on the reform of the facilities and the Fund's long-standing policies on access limits.

Lastly, let me add that the new arrangement should be seen as a precautionary measure and, in this respect, it also represents an important element of a crisis prevention strategy. I therefore express the hope that Brazil will not find it necessary to make any drawings under it.

The progress made to date in fiscal consolidation is impressive, all the more so, as it has not been confined to the federal government but has also been pursued by state and local governments.

Nevertheless, a further increase in the primary surplus is needed to offset the adverse effects on the public debt of the recent depreciation of the real and the widening of interest rate spreads on Brazilian bonds. I welcome the fact that this additional fiscal adjustment is concentrated on the expenditure side of the fiscal accounts while attention is given to possible adverse implications for the weaker parts of the population. I am also concerned, as other Directors, about the possible distortionary effects of some tax measures.

On debt sustainability, while I welcome the commitment to maintain a significant primary surplus, I am concerned about vulnerability risks. The sensitivity analysis summarized in Figure 5 of the staff report indicates three different possible channels of vulnerability for the debt pattern: interest rate and exchange rate changes, as well as growth decline. It is not fully clear to me, whether the analysis suggests any ranking in the vulnerability risks involved but, more importantly, I am concerned with the fact that negative shocks coming from the different channels could, and probably would, accumulate rather than take place independently. While this is clearly a "worst case scenario" it is, regrettably, not necessarily one with a low probability, given the current global environment. And it is one that would put to test the appropriateness of the proposed measures. I would appreciate staff comments on this point.

Brazil's experience with the operation of the inflation targeting framework is generally positive. However, inflation has recently flared up on account of the unanticipated steep depreciation of the real as well as the impact of large increases in administered prices. I welcome the strong and relatively swift action that the authorities have taken to contain the second round effects of these developments, which posed a significant threat to the attainment of the official medium-term inflation target.

However, I hope that it will prove possible to reverse some of this action if the program succeeds in restoring confidence and reversing in part the fall in the external value of the real. In this respect I would appreciate more details on exchange rate management and the role the daily intervention will have in the future. Like Mr. Bernes in his statement, I am not fully convinced, at this stage, of the rationale of such an intervention rule. Does staff consider that the rule is still the most appropriate in the current situation? This point, in part, relates to longer-term considerations about the exchange rate regime, to which I will return.

Staff presents the stance of policies at the present juncture as "procyclical." It is true that both fiscal and monetary policy have had to be tightened in the recent past against the background of decelerating economic growth. At least a partial offset is provided by the large depreciation of the real, which can exert a stimulatory effect on exports. The extent of such an effect, however, depends upon the short term elasticity to exchange rate changes and I would like to hear comments on this.

Looking at the longer-term aspects of competitiveness and growth, I welcome Mr. Portugal's indication that the authorities continue to attach high priority to the objectives of trade liberalization and regional integration. While this is encouraging, both for Brazil and for the region, it would be useful to spell out in some detail the specific actions that will be taken in pursuit of these objectives, in order to dispel doubts that emerged in the wake of the recent difficulties in trade relations with Argentina and to convince economic agents that Mercosur is indeed a trade- and growth-enhancing initiative.

In this respect and in conclusion, turning again to the exchange rate regime, let me echo Mr. Yagi and Mr. Toyama in their statement about the opportunity to consider, in a longer-term perspective, the need to accompany further trade deepening in the region with exchange rate agreements that, with the appropriate amount of flexibility, maximize the benefits of integration, especially between Brazil and Argentina, by making different national policy stances mutually compatible.

Mr. Wei made the following statement:

I would like to thank the management and the staff for their swift response to Brazil's request and for their efforts in preparing this well focused paper. I also thank Mr. Portugal for his very comprehensive and insightful statement. Since the implementation of the current Stand-By Arrangement, the Brazilian authorities' performance has been excellent with each of the seven reviews having surpassed our expectations. The authorities' skillful macroeconomic management, prompt response to weaknesses in the economy, timely remedial measures, and forceful structural adjustments have put the economy on better and solid footing. Unfortunately, the domestic energy crisis, contagion effects from the Argentine turbulence, and the weakening world economic outlook, have undermined growth prospects and sent the real on a sharp downward trend, complicating the ongoing economic consolidation process. I believe that the new arrangement requested by the Brazilian authorities will reinforce their policy endeavors and enable the economy to weather the external shocks. Given the authorities' strong track record and the strong program, we fully support the request for a new Stand-By Arrangement. I broadly agree with the thrust of the staff appraisal, but would like to make a few comments for emphasis.

Progress in fiscal consolidation has been remarkable. This year and next, the authorities have firmly committed to maintaining a higher primary surplus of the consolidated public sector. In view of the impact of the large exchange rate depreciation on the public debt ratio, further improvement in the fiscal position is desirable. The staff highlights that the comparatively high revenue/GDP ratio and rigid expenditure structure may limit the authorities' ability to maneuver in improving the fiscal account under the current structure. Therefore, I welcome the authorities' intention to advance indirect taxation reform and their efforts and measures to reduce expenditure. Improved public debt management also has an important bearing on the debt ratio. I note that both staff and the authorities caution that a large share of domestic debt is foreign exchange-indexed or in the form of floating rate bonds, which are subject to exchange and interest rate fluctuations, despite the merits of longer maturities. I join staff in welcoming the authorities' commitment to reduce the share of floating rate and exchange rate-indexed bonds in public debt when market conditions permit.

On monetary policy, I commend the central bank for its prompt policy reaction to the inflationary implications arising from the sharp depreciation of the real and the energy crises. In general, monetary policy within the inflation-targeting framework has operated smoothly despite a somewhat upward adjustment in the target band which was unavoidable in the face of such significant shocks. The inflation targets for 2002 and 2003 are set at 3.5 percent and 3.25 percent, respectively, sending a strong signal to the market of the authorities' firm commitment to keep inflation low, thus improving market perception. Under such a framework, intervention in the foreign exchange market should be limited to smoothing market operations. Mr. Portugal assures us that the authorities will not intervene in the markets above the amount announced, unless under extraordinary circumstances. We also believe the rationale for lowering the NIR floor is reasonable.

On structural issues, I would like to join staff in welcoming the authorities' initiative to draft a new central bank law enhancing the bank's operational autonomy and legislation to improve capital market supervision by unifying and strengthening the various regulatory bodies. The successful and timely disposal of six federalized state banks and improved federal bank management of the federal banks are also important. Further advances in these areas will enhance the soundness of the financial sector.

The energy shortage is exogenous and outside the government's control. The authorities' skill in applying temporary and market oriented remedial measures on both the demand and the supply side have proved helpful and effective in mitigating the impact of the shock A more fundamental solution to such a supply shock is to expand the stable supply capacity and reduce regulatory bottlenecks. We are encouraged that the government is doing its best to address this issue in a straightforward manner.

Finally, let me echo the view of Mr. Mirakhor in his statement that the program is ambitious and faces risks, mainly from the external environment. However, we are confident that the authorities will be able to implement the program successfully given their strong past record and strong commitment to the program, especially their readiness to take additional policy measures if circumstances warrant.

With these remarks, I wish the authorities every success in their economic consolidation endeavors.

The staff representative from the Western Hemisphere Department (Mr. Perez), in response to questions and comments by Executive Directors, made the following statement:

A number of Directors have referred to the problem of expenditure rigidity and the increased earmarking of revenues in Brazil, which is a concern the staff shares. In fact, it became obvious in the last round of negotiations with the authorities, when we were looking for additional fiscal adjustment measures, that the room to maneuver on the spending side in the federal government was limited. Clearly, reducing expenditure rigidity is more of a medium-term project, as the current government in Brazil was in its last year before elections. But, this is an issue we will continue to discuss with the authorities, in order to find ways to reduce expenditure rigidity.

Some Directors referred to the limitations in implementing the necessary legislation for pension reform in the civil service sector. This is an important legislation because it would permit the government to tax civil service pensions, and indirectly reduce spending rigidity in that particular category. Other Directors questioned how spending policies were exactly implemented, and asked to identify the areas in which expenditures were being cut. In this regard, it is important to consider the public sector as a whole. At the level of the federal government, expenditure cuts were made in 2001 across the board, on various infrastructure ministries, such as transportation and telecommunications. But more importantly, for 2002, the cuts are concentrated, as pointed out in the staff paper, in terms of GDP on the payroll and in terms of capital investment, in some areas of infrastructure spending. Some Directors questioned how it is possible to emphasize spending cuts while at the same time stating that there are increases in investment, in energy, and in social spending. Perhaps, the staff paper was not as clear as it could have been. The increases in energy investment are conducted by the federal enterprises, and not the federal government.

Regarding to what extent the program is relying unduly on the financial transaction tax, which is a distortionary tax—as acknowledged by the staff and the authorities—the problem is that it is very difficult to come up with a revenue measure that would generate close to 1.5 percent of GDP in the short run. The authorities have requested technical assistance from the Fiscal Affairs Department to revisit the areas of indirect taxes, and substituting the CPMF will probably involve increasing substantially the value-added tax rates. This is an option that the authorities are willing to pursue, but they have to coordinate it, with other aspects of the reform of indirect taxes. The current government views the extension of the CPMF as a temporary measure. They are looking for ways to exempt particular transactions. Minister Malan, for example, announced that stock market transactions will be exempt from the CPMF. The impact of this exemption, in terms of revenue, is not very large, but in terms of efficiency, and in terms of giving the signal that the authorities are finally moving in the right direction, is very important. It should be noted that the staff shares the concerns of a number of Directors about the distortionary impact of this tax.

In relation to net public debt dynamics, some Directors asked whether some of the shocks experienced by Brazil could lower growth more and result in a more depreciated exchange rate than envisaged in the staff simulations. This is possible and there appears to be few alternative options to the authorities' current actions: strong fiscal policy and maintaining a tight monetary policy. Unfortunately, there is little room to maneuver in terms of interest rate tightening and advancing structural reforms.

Mr. Yagi asked about the change in the downward trend in interest rate spreads in the financial system. Figure 4 in the staff paper indicates the spreads for enterprises start rising again in November 2000 after a period of consistent decline, whereas the spreads on consumer lending have continued to come down. There is no easy answer to this question. This is something that happened in the last several months. It appears that the spreads in loans to business enterprises are more sensitive to the changes in the overnight rate and the latter have been increasing, as you know. Another hypothesis is that there could be a threshold at which point certain enterprises could decide to finance themselves from other sources such as retained earnings or outside sources. Under this scenario, borrowers that remain in the financial system are higher risk borrowers, which would result in a higher spread.

On exchange rate policy, Directors asked what were the exceptional circumstances this week that warranted the foreign exchange intervention. Unfortunately, Brazil continues to be vulnerable to contagion, because of its very large external borrowing requirements. In addition, there have been a number of shocks at the beginning of the year: the energy crisis in May and the slowdown in the world economy. These developments have been reflected in Brazil in a deceleration in foreign direct investment inflows, which puts pressure on the foreign exchange market. Brazil also experienced at the beginning of the year political difficulties in the government coalition concerning the election of new leadership in the congress. Recently, the political parties have become more active, prior to the election next year. These developments, and the lack of assurances, create much concern in the private markets. I am told that this week the liquidity in the foreign exchange market this week, because investors, who are in a position to trade or sell foreign exchange, are holding back until the markets open in New York next week. And for this reason, more rumors started in Brazil, like the possibility of credit lines being closed to Brazil, which is unfounded by recent information. These developments have caused turmoil in the bond markets and have created an environment, in which the authorities felt it was necessary to react.

There has been a debate about the practice of daily interventions in the foreign exchange market, of selling small amounts of dollars. This is not a policy the staff considers to be viable and we do see some risks. We share the concerns of many Directors that interventions in the foreign exchange markets may be counterproductive because international reserves are scarce. The authorities' rationale for starting the policy of daily intervention is based on the analysis they conducted around March or April of this year, when they concluded that there was a potential balance of payments financing gap in the private sector. As we explain in the paper, the public sector has covered its financing needs for the rest of the year, but ex ante, the analysis revealed that there could be pressures in the foreign exchange market in the private sector, and the authorities decided that announcing a policy of intervention might tend to have a calming effect on markets. In the event, the practice does not seem to be working very well in that sense. On the other hand, the authorities feel that, now that they have embarked on this policy, it may be counterproductive to change it. This is a topic we frequently discuss, just like the discussion about the level of intervention in terms of selling foreign exchange indexed bonds.

Mr. Törnqvist asked whether it is in the authorities' discretion to decide what constitutes exceptional circumstances or whether the staff is consulted in deciding when to intervene.

There are consultations and understandings with the staff, for example, about what the general policy should be to try to reduce the stock of the foreign exchange-indexed bonds over time. There is a resident representative in Brazil and we talk frequently to the authorities. Indeed, discussions have been taking place with the BCB four or five times in the last 24 hours. However, there is an understanding that it is the aim of the policy that, if the authorities decide to intervene, it has clear implications for interest rate policy. There must be consistency: interest rates cannot be lowered at the same time that interventions in the foreign exchange market take place.

The Deputy Director of the Policy Development and Review Department (Mr. Allen) pointed out that the staff's reasoning for a precautionary SRF arrangement was laid out in paragraphs 3 and 4 of the staff paper. The use of the SRF in a precautionary way had not been discussed at the time when the SRF had been established. In fact, there had been an implicit assumption that the CCL would be the precautionary facility. But, Brazil had not reached the point of becoming eligible for the CCL, but now needed financing. So, the SRF was the appropriate instrument.

The SRF had been designed for member countries experiencing exceptional balance of payments difficulties due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence, as reflected in pressure on the capital account and the member's reserves, the Deputy Director continued. That characterized Brazil's current predicament. The important criterion was that there had to be an actual need rather than just a potential need that might arise at some point in the future. Brazil had been experiencing pressures on the exchange rate and bond prices. The need for higher gross reserves in Brazil indicated that the country had a large balance of payments need, which would justify access under the SRF. In fact, if the Board approved the current arrangement, Brazil would be able to draw immediately under the SRF because of that immediate balance of payments need. However, the authorities were not obliged to draw under the available arrangement and had indicated their intention to treat it as precautionary. With an approved arrangement, Brazil's gross reserves would implicitly increase by the amount of resources available from the Fund, and, in fact, the authorities would maintain the resources in their account in the Fund, rather than in the central bank. Thus, the use of the SRF in a precautionary fashion was considered by the staff to be entirely consistent with the SRF decision and, indeed, with what the Fund had been trying to achieve in Brazil, which was to strengthen market confidence.

Mr. von Kleist said that he supported the Brazilian request. He wondered about the drop in investor confidence in Brazil, which could be regarded as gradual rather than sudden. In addition, Mr. Portugal's remarks that the Brazilian authorities had had comfortable access to international capital markets seemed to contradict the staff's remarks. The current discussion seemed to be moving on somewhat different levels with respect to the different theoretical and practical dimensions of the issue of market access.

Mr. Collins welcomed the authorities' intention to treat the arrangement as precautionary and that most of the resources would be on SRF terms. In a way, it was puzzling that a SRF arrangement—rather than the CCL—could be precautionary. The SRF was supposed to be the kind of response to an immediate need. The staff's comments in that respect had been quite convincing. Independently from the case of Brazil, the consistency of conditionality in the case of a precautionary SRF, when a country would draw at some point in the future after it had been granted the right to draw, but where its policies had gone off track, deserved further consideration. Whereas, under a CCL, access to drawings was subject to continuous conditionality. There could be a risk of disconnect or lack of continuity in the use of the SRF that needed to be discussed in the future.

The Deputy Director of the Policy Development and Review Department (Mr. Allen) explained that one of the first conditions to be fulfilled to be eligible for a CCL arrangement was that there not be an immediate crisis. In fact, Brazil was in a difficult situation. The pressure on the exchange rate and developments in bond prices indicated that the loss of market confidence in the last three or four months was sudden rather than gradual. The fact that Brazil had weathered the situation through a depreciation of the exchange rate was not an indication that the crisis was not sudden. Although there was a need for a general discussion of the range of instruments for different circumstances in general, the Fund had been able to meet Brazil's needs at the moment by using the SRF.

Mr. Portugal agreed with the staff that the CCL was intended for cases in which contagion had not yet started, and that in the case of Brazil severe difficulties had already been manifested. Brazil had a good track record and could be eligible for a CCL. The other option would be a precautionary Stand-By Arrangement, although the Board might not prefer granting Brazil such a large arrangement on Stand-By Arrangement terms. That explained the mixed use of Stand-By Arrangement and SRF resources. The program had to be large and front-loaded because the idea of having a smaller arrangement that could have been augmented at a later stage would have had no immediate impact on confidence. In such case the authorities would have preferred to wait and ask the Fund for a larger arrangement at a later stage.

The increasing net debt-to-GDP ratio from 49 percent to 52 percent, and the estimated increase to 54 percent, despite the fiscal adjustment, was indeed disappointing, Mr. Portugal remarked. However, it was important to understand the origin of that additional five percentage point increase. One percentage point was due to the federal government's effort for more transparency and recognized liabilities that had been in the balance sheet of federal banks, which had no additional macroeconomic impact; another three percentage points of that increase was due to lower than expected economic growth. The growth rate had been 2.2 percent of GDP in 2001 and was expected to be 3.5 percent in 2002. The remaining two percentage points were due to increasing interest rates and the depreciation of the exchange rate. Irrespective of the causes, the debt had to be repaid, which made it necessary to generate fiscal revenues. However, it was doubtful whether it was necessary to repay the entire debt immediately, because fiscal policy would not respond immediately to any change in the exchange rate or to any increase in interest rates. It was impossible to bridge that five percentage point gap in one year with fiscal measures, because the primary surplus would have already reached 3 percent of GDP. An increase in the primary surplus from 3 percent to 8 percent would have been extremely difficult and not advisable, such a level of adjustment would have been highly destructive of national prosperity in a situation of decelerating GDP growth. Clearly, that would have been contrary to the Fund's mandate and purpose. Although there was no ideal debt-to-GDP ratio, a lower level would be preferable to a higher one. However, there were countries that had sustained a debt level of 54 percent of GDP. In that respect, it would be important to achieve sustainability over the medium term, which was possible through the existing degree of fiscal effort.

There still seemed to be some concern among Directors about the high share of floating rate and the increase in dollar indexed debt in Brazil, Mr. Portugal continued. It was important to distinguish between the strategy that had been developed and the tactics for its management. The strategy had clearly been in line with what Directors had suggested, which was to limit the participation of dollar indexed liabilities, to reduce the participation of floating interest rate bonds, and to increase the participation of fixed rate instruments. The implementation of that strategy depended on market conditions, and one had to be mindful of those conditions, because the options would be limited. On many occasions, only second best and third best options would be available of which the public had to be convinced.

Looking back at his past experiences in the Ministry of Finance in Brazil in the field of debt management, in 1993 the share of fixed rate debt had been 26 percent with a very low maturity of 7 to 14 days, Mr. Portugal recalled. Most of the debt at that time had been indexed either to the exchange rate or to price indexes, because it was important to estimate future inflation in order to bid in an auction for a fixed rate bond. At times of high and accelerating inflation, as Brazil had experienced, the costs of inaccurate estimates were very high, including possible bankruptcies. Under those circumstances, it was very difficult or impossible to issue fixed rate debt. After the authorities in Brazil had stabilized the situation and inflation had been reduced, the share of fixed rate debt in total debt had been gradually increased. In 1996, for instance, it had been 61 percent, and exchange rate-indexed debt had dropped from 17 to 9 percent. With the Asian crisis, Brazil had experienced a sudden increase of 20 percentage points in interest rates in one day, from 20 to 40 percent, which had led again to a reversal of the situation until the share of fixed rate debt had started to increase again under the Fund-supported program. Those experiences warranted a certain degree of caution with respect to the points raised by a number of Directors. While it was true that a large proportion of floating rate debt or dollar-indexed debt would increase the sensitivity to exchange rate fluctuations, that would work in two directions, leading to possible debt servicing problems in case of an exchange rate depreciation, and to gains in case of an exchange rate appreciation. At the same time, a high proportion of dollar-indexed debt would substantially reduce the rollover risk of that debt, which had allowed the Brazilian government to borrow mainly domestically instead of abroad. That was a very important consideration to bear in mind, as the different trade-offs needed to be taken into account. The dollar-indexed debt in Brazil would be completely paid in reals at maturity, which would not create any pressures on the international reserves, unlike in the case of Mexico, where tesobonos had led to a further deterioration of the debt situation. In Brazil, the pressures would be on the fiscal side.

Mr. Wijnholds asked how much the Brazilian currency was undervalued, which would also be relevant with respect to the issue of dollar-indexed bonds.

Mr. von Kleist reiterated that countries experiencing serious macroeconomic difficulties needed to implement adequate adjustment measures to address imbalances and misalignments.

Mr. Portugal agreed generally that adjustment measures were necessary. However, timing was important as it would not be feasible to increase the primary surplus in one year from 3 to 8 percent of GDP. In a situation in which the level of GDP growth was already falling, sudden adjustment measures were destructive to national prosperity, and the Fund should not advocate the adoption of such drastic measures. However, the case would be different if the authorities of a country were responsible for the deterioration, which, in turn, would require substantial adjustment measures. But, in many recent cases, developments had been driven by exogenous rather than domestic factors.

Mr. Palei stated that, in response to Mr. Portugal and other Directors, he would have preferred the use of a Stand-By Arrangement in the case of Brazil as opposed to the SRF. There was much confusion about the benefits and costs of the use of SRF versus Stand-By Arrangement resources, as the Board's discussion of paragraph 15 of the staff paper had demonstrated. In the case of Brazil, that decision had been based on the nature of the balance of payments problems, as Brazil not only suffered from contagion from the bond markets and the recession in Argentina, but, at the same time, had serious structural problems in the fiscal area, which constituted a problem that had to be addressed in the medium-term, as many Directors had pointed out. The necessary adjustments in response to the supply shock in the energy sector would also constitute a medium-term problem. The use of SRF resources in such circumstances was questionable and would rather warrant a Stand-By Arrangement. As a signal of confidence to the markets, it remained doubtful whether the SRF was better than a Stand-By Arrangement, just because the SRF was a short-term facility and the maturity of the instrument was certain. The use of the SRF also suggested to financial markets the existence of a full-blown crisis.

The staff representative from the Western Hemisphere Department (Mr. Perez) stated that it was the staff's opinion that the exchange rate had overshot in recent weeks in Brazil. An analysis focusing on the sustainability of the current account and including factors such as purchasing power parity was likely to indicate that Brazil's currency was substantially overvalued. It was difficult to evaluate how much the uncertainty in capital markets would weigh in as a factor in such an analysis. The staff expected the real to appreciate in real terms in the months to come if policies had the expected results and the external environment informed.

On the question of possible current policy options, the staff believed that the authorities had little room to maneuver, the staff representative remarked. However, the authorities had tried to use the options available under the program, such as the tightening of monetary policy, the strengthening of fiscal policy in a reasonable way, and allowing the floating exchange rate regime to operate. Although the latter allowed the exchange rate to absorb some of the external shocks, the depreciation of the currency had had a negative impact on the debt dynamics. The authorities had increased interest rates by 375 basis points in the last four months, which had led to a further deterioration in the debt dynamics. The staff believed that maintaining a steady course of strong fiscal policy would improve the economic situation; this was already becoming evident in the trade balance. If foreign demand recovered in 2002, a positive turnaround would be possible.

Mr. Jonas asked whether a reduction in interest rates and a strengthening of the currency would improve the debt dynamics, as had been stated by Mr. Portugal. The floating part of the debt was tied to overnight market rates, which had already incurred higher interest rate payments. A reduction of interest rates would lead to a slower accumulation of public debt, but would not lead to an actual reversal. The exchange rate appreciation, in contrast, would lead to a reversal to the extent that the dollar-linked debt would not have been redeemed at the more depreciated exchange rate. Thus, a continuous roll over of debt and, eventually, the retirement at the appreciated exchange rate would lead to a beneficial effect.

Mr. Portugal emphasized that a reduction in interest rates would have different impacts, depending on the kind of bond. The difference between the sale of a 2-year fixed rate bond at 19 percent, compared to the sale of a 3-year floating rate bond at initially the same rate, was that the floating rate bond adjusted immediately to a lower interest rate–with less interest to pay from the first day up to the end of the maturity of the bond. In the case of the fixed rate bond, payments at 19 percent had to continue until the end of the maturity of the bond.

Mr. Guinigundo made the following statement:

We are pleased to join the other Directors in supporting the proposed decision to grant Brazil a Stand-By Arrangement as a precautionary move to help ensure the effectiveness of its strong policy measures in response to both external and domestic shocks.

Brazil's macroeconomic fundamentals continue to show potential for economic growth, despite the recent economic weakening of global markets. Therefore, it deserves financial support from the Fund. Moreover, the downsides in the Brazilian economic situation are factors mostly beyond the control of the authorities.

Second, Brazil has a strong record of undertaking prudent macroeconomic policies and structural reforms. While Table 1 indicates that Brazil failed to achieve some indicative targets, including those on outstanding public sector debt for January to March 2001 and January to June 2001, the monetary sector target for June 2001, and two aspects of structural benchmarks for end-March 2001 and end-June 2001, all the performance criteria have been met. This reflects the capacity and strong commitment of the authorities in putting in place the necessary policy framework to achieve both stability and growth.

Third, we believe the proposed program, based on its four main elements, is a reasonably ambitious and broad-ranging program. It is one that builds on the progress made under the existing program, and therefore one that could deliver the objectives of sustainable growth and employment in the context of low inflation and improved living standards for the Brazilian people.

As Mr. Yagi and Mr. Toyama, we have some comments regarding the difficult task of ensuring the success of the new adjustment program.

One key issue of the discussion concerned debt sustainability in light of the deteriorating macroeconomic situation. At the time of the 7th review under the existing Stand-By Arrangement, many Directors were concerned about the high debt-to-GDP ratio, which seemed to increase despite better than programmed fiscal performance in light of the weaker external environment. We recognize Mr. Portugal’s explanations about the increase in the debt-to-GDP ratio, but we share the views of other Directors that fiscal policy could be appropriately tightened to ensure that the debt dynamics remain manageable. We also support the call for a reduction in the earmarking of revenues to achieve greater flexibility in the budget process.

We also join other Directors in commending the authorities for their good progress regarding the maturities of the debt, while, at the same time, we encourage them to continue their efforts to change the debt composition by reducing the share of the indexed rate and floating ranks bonds in total, as Mr. Portugal said, market conditions permitting. We underscore the importance of continued adherence to the inflation targeting framework. Price flexibility is the primary mandate of central banks. To the extent that the price objective is not compromised, central bank operations could lower interest rates or pursue expansionary monetary policies. Moreover, Brazil's adoption of a flexible exchange rate regime and the authorities' flexibility to intervene in the foreign exchange market is not necessarily curtailed in the context of an inflation targeting framework. The monetary authorities should be given the latitude to undertake foreign exchange market interventions to promote price stability, but not to defend a certain level of the exchange rate. It is true that several Directors expressed their concern during the Board discussion about the authorities' foreign exchange interventions. But the authorities intervened in a situation of extreme volatility and high liquidity. Under the new program, the authorities have adopted a policy of limited regular, daily interventions in the foreign exchange market. Whether this stance will promote stability in the foreign exchange market and price stability is something for the authorities to determine. The staff noted in paragraph 34 of the report that market participants had not immediately understood the intention behind this policy and the authorities' intention not to defend any particular exchange rate. Has this misunderstanding been resolved?

We agree with other Directors in encouraging the authorities to continue their structural reform policies, like the privatization of the federalized state banks, the pursuit of the pension reform, the introduction of a social security contribution by civil servants, the implementation of more fundamental reform measures in the electricity sector, and the legislation in favor of a more independent central bank.

Last, the authorities have a well-developed strategy for communicating with the markets and for making financial data available to the public in a timely manner. However, there is still scope for improving the quality of the data. We encourage the authorities particularly to improve their public sector statistics, which would make financial surveillance easier.

Mr. Alosaimi made the following statement:

Over the past few years, the Brazilian authorities made impressive progress in enhancing the economy's fundamentals, strengthening the fiscal position, and bringing inflation down. These improvements notwithstanding, the convergence of a number of exogenous factors this year weakened growth and put pressure on interest and exchange rates. Here, I am encouraged by the authorities' swift response to developments as noted in Mr. Portugal's helpful statement. Indeed, the authorities' request for a new Stand-By Arrangement to support their strengthened efforts attest to their commitment. As I am in broad agreement with the program's priorities, I will be brief.

Brazil's success in retaining investor confidence is critical for economic prospects. In this regard the focus on further fiscal effort to improve debt dynamics is appropriate. Here, I welcome the authorities' cognizance of the need to focus on expenditure containment. However, expenditure rigidities, the earmarking of revenues, and the need to increase spending in the energy sector could make this task difficult.

It is also important to fully recognize the risk of slower than projected growth on revenue performance. Indeed, continued weak global performance may further undermine confidence. Therefore, the authorities' policy resolve is likely to be severely tested if the fiscal objectives are to be realized.

Another important element of the program is the focus of monetary policy on achieving the inflation target. In this regard, the strong response to increasing inflationary pressure is reassuring. This policy response, combined with adherence to the fiscal targets and continued efforts to strengthen structural reform, should go a long way in building confidence and stabilizing the exchange rate. In this regard, I welcome the Central Bank's commitment to limit intervention in excess of the established limits except in extraordinary circumstances. I am also reassured by the Central Bank's statement that it will limit any increases in the outstanding stock of U.S. dollar indexed bonds.

That said, high interest rates take a toll on the economy, especially if they are maintained for a long period. Therefore, while it is clear that tight monetary policy is necessary to send a signal of the authorities' commitment to lower inflation at this time, it is important to reduce interest rates as soon as it becomes evident that inflation reduction is on target and confidence has increased.

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

Mr. Duquesne made the following statement:

As was just mentioned by Mr. Alosaimi, under the previous program the Brazilian economy has performed well and the authorities have succeeded in stabilizing their economy and reducing inflation despite a large devaluation of the currency. When we discussed the seventh review of the previous program, some negative developments were appearing on the horizon which have now been confirmed.

Against this background, the Brazilian authorities have requested a new program with an increased access. Given the good cooperation between Brazil and the IMF and Brazil's good implementation record, I support the proposed decision. But let me add that on the precautionary aspect of the SRF, Mr. von Kleist has a valid point. We believe that such issue should be discussed in the forthcoming review of the Fund's high level access.

As regard, the program's assumptions, I note that the slowdown in recent months has been rather impressive and I am wondering whether the growth forecast, although it has been revised drastically, is not still too optimistic.

This is all the more important because Brazil's debt situation seems to allow only limited options in terms of policy mix to react to a weaker growth. Mr. Bernes catches perfectly in his statement the dilemma facing the authorities. Brazil's external vulnerability leaves little choice other than to run pro-cyclical policy, since with interest payments close to 10 percent of GDP, the country cannot afford to increase its indebtedness. Mr. Mozhin and Mr. Palei rightly note that weaknesses in the fiscal area should have been addressed earlier to strengthen the country's resilience and to avoid to recourse to a pro-cyclical policy.

We note that after the recent effort made on the revenue side, fiscal adjustment should rely on expenditure cuts. However, I am wondering whether this is a credible option given the rigidity of the spending structure. Also, I see some paradox in contemplating reduction in investment spending while at the same time having to increase investment in the energy sector. Furthermore expenditure cuts are everywhere difficult to implement in an election year. Hence, I am wondering whether it is right to put most of the burden of the adjustment on the fiscal side, particularly if we want to see the social spending protected.

Turning to monetary and financial issues, even after the explanations given by the staff, I am still puzzled by the decision to pre-announce a certain level of intervention. In my view either you run an inflation targeting and you refrain from interventions or you run a managed float and then you do not pre-announce the limit nor the time of your intervention.

The size of debt service makes it critical to reinforce the Central Bank's credibility in order to reduce market rates. Furthermore, given the impact of floating rate and exchange rate-indexed bonds on the debt dynamics, we noted, positively, the authorities' intention, recalled by Mr. Portugal, to reduce their share in the public debt.

Before I conclude, I would like to concur with Mr. Yagi and Mr. Toyama's remarks in paragraph 5 of their statement. It is clear that Brazil cannot be analyzed in isolation and I agree that the Fund stands in the best position to address this consideration, especially in the actual period.

To conclude, let me reiterate that Brazil's resilience to external shocks could be enhanced by a steadfast implementation of structural reforms, particularly, as emphasized in the staff report, in the fiscal and the financial sector.

Mr. Collins made the following statement:

We agree with the thrust of the staff paper and endorse the authorities' request for a new arrangement. Brazil has performed strongly under the existing Stand-By Arrangement, but events in Argentina, which are wholly outside Brazil's control, and the domestic energy crisis, which is partly outside its control, have weakened market confidence. Against the background of an already gloomy world outlook, compounded by the tragic events of September 11, 2001, it is entirely appropriate for the Fund to provide precautionary financing for Brazil, a country that is following sound policies and is taking corrective actions.

The authorities' commitment is documented by their efforts to further tighten fiscal policy and it is encouraging that they expect monetary policy to be on track regarding the 2002 inflation target, despite recent slippages. I just wonder how credible that expectation is, but appreciate the determination in pursuing that goal. However, I do agree with Mr. von Kleist on the vast complexity of the consultation arrangements surrounding the inflation target set out in the paper. I also share Mr. Duquesne's astonishment about how it is possible to maintain a pure inflation targeting framework but to some extent appear to be targeting the exchange rate. Others, like Mr. Törnqvist and Mr. Quarles, have also questioned this intervention policy.

Substantial underlying vulnerabilities remain. Brazil's external financing needs are high, leaving the country vulnerable to any shock to the supply of capital to emerging markets in general. The public debt structure remains to be of short maturity and duration despite recent improvements and political uncertainty remains in the run up to the 2002 elections. To ensure that debt dynamics remain stable, the fiscal effort envisaged in the program needs to be sustained beyond the duration of the program. I have some concerns about the concentration of the fiscal effort on the financial transactions tax because of its distortionary nature. This resonates with a debate that seems to be restarting about the Tobin tax, and I hope that people will remember the lessons from individual examples in that up-coming debate.

The weakness of the real poses a further threat to Brazil's financial stability, as interest rates may have to be raised to avoid second round effects on inflation. The cost of servicing foreign currency-denominated debt poses another threat, for both the public and the private sector.

Does the staff believe that the precautionary nature of the Stand-By Arrangement will be respected, given that the forecasts incorporated in the paper seem very optimistic in relation to the existing consensus at the moment. Can staff think of a scenario in which the Brazilian authorities actually have to draw under the program?

Insulation from contagion is obviously the main rationale for the new arrangement. The staff mentions some of the propagation mechanisms for external shocks, in particular the exchange and interest rates. But, are there other factors not covered yet, such as common creditor and trade linkages, particularly in relation to Argentina, which received 12 percent of Brazilian exports in 2000?

The market reaction to the announcement of the new program was certainly muted. Mr. Quarles indicated earlier that there were market concerns about debt levels in Argentina. I wonder if the staff shares that view.

I welcome the authorities' plan to restructure four federally owned commercial banks by injecting new capital in some of the country's largest banks. The plan will improve the soundness of the banking system and enhance the overall transparency of fiscal policy, as it will clean up 12.5 billion real of hidden liabilities of the consolidated public sector, which is 1 percentage point of GDP. The subsidy cost of all new sub market rate loans will be fully recorded in the central government budget. In this respect, I welcome Brazil's wish to participate in the FSAP.

Finally, I agree with Mr. Quarles's comments about the desirability of publishing this report.

Mr. Skurzewski made the following statement:

The Brazilian economy enjoyed strong growth up to the first quarter of this year. Since then this trend slowed down sharply due to combined effects of unfavorable global economic trends, in particular in neighboring Argentina, severe energy shortage, low commodity prices and uncertainty surrounding next year's presidential elections. With the new program the authorities demonstrate their strong commitment to keep the Brazilian economy on track. I have no doubt that this commitment can be successfully met as it was in the recent past and I support the new arrangement.

The last few months have made it clear that Brazil remains virulently vulnerable to deteriorating financial market sentiments because of its continued reliance on domestic and foreign capital. Despite higher-than-expected primary budget surpluses total net public sector debt is expected to increase again some 54 percent this year as a result of the strong depreciation of the real and the marked rise of Brazilian sovereign bond spreads and domestic interest rates. Moreover, the debt dynamics could accelerate if one or several of the numerous downside risks Brazil is presently facing should materialize. The sensitivity analysis shows that public debt is strongly influenced by changes in the exchange rate and real growth rates. This proves the need for appropriate debt management policy accompanied by the envisaged medium-term fiscal consolidation—indispensable for controlling debt level and for strengthening market confidence. I note that the average maturity and the duration of the outstanding securitized federal debt has already been lengthened. Furthermore, floating interest rates on foreign exchange-indexed debt are less difficult to rollover.

Fiscal targets have been outperformed under the previous program, which may be attributed to expenditure restraint and improved tax administration under the roof of the Fiscal Responsibility Law. I fully agree that it would be inappropriate to increase the fiscal burden on the economic subjects in the current status of the business cycle. Exempting stock market transactions from the financial transaction tax is a useful modification in this regard.

Turning to monetary and exchange rate policy, since the adoption of the inflation targeting framework, the exchange rate has been considered only of importance with respect to its effects on inflation, and this subordination of currency stability to price stability should be maintained also in the face of this year's real weakness. I thus welcome the BCB's commitment to the floating exchange rate regime, however, when confronting this intention with the announcement to use 6 billion dollars for limited daily foreign exchange interventions this year I feel somewhat confused, like Mr. Bernes and others. These interventions seem to have had no noticeable effect on the real so far. Moreover, analysis by the BCB in its June inflation report show that the pass-through of the real's depreciation to the consumer price index (IPCA) up to May has been small.

I thus would advise the central bank to keep these international reserves ready for really extraordinary circumstances. The same should apply to the additional 5 billion in international reserves that is to become available with the reduction of the performance criterion of net international reserves in the new program.

Finally, in view of the regional importance of the Brazilian economy but also in view of the increased role of transparency in economic policy making, I welcome the authorities' intention to prepare a fiscal transparency ROSC module and participate in the FSAP, and I regret the decision not to publish the staff paper.

I wish the Brazilian authorities success in their implementation of the new program.

The staff representative from the Western Hemisphere Department (Mr. Perez) said that, on Mr. Guinigundo's question about exchange rate policy, the market understood the central bank's policy of intervening in the foreign exchange market because it sold $50 million every day. The central bank was constantly reevaluating options regarding exchange rate policy, but they probably felt that, under the current circumstances, it was best to continue the policy they had been pursuing in the past.

Regarding the authorities' intention to request a precautionary Stand-By Arrangement, a possible strategy could be that they wanted to show the markets that they had the possibility of increasing gross reserves in case of difficult circumstances, the staff representative explained. However, the authorities would prefer not to draw under the arrangement. On the other hand, they did not exclude the possibility to do so if the need would arise.

On whether the inflation target for 2002 would be in jeopardy due to the higher than expected pass through of around 20 percent, the staff representative agreed that this was clearly a risk. However, new information suggested that the pass through might be less than 20 percent. Most recent estimates showed that the full pass through in 18 months would be less than 15 percent. Based on pure econometrics, and looking at the period after the floating of the exchange rate, that result could be expected. In addition, aggregate demand in Brazil had been weakening, which would in turn make it more difficult to pass through the effects of a depreciation. There was the sense in the market that the exchange rate had strongly overshot, which could moderate the behavior of possible sellers, who would see that as a temporary phenomena. Besides all those factors, the central bank authorities currently had more credibility, which they had earned during the last two years. If the authorities continued to aim for the 3.5 percent inflation target for the end of 2002, that would support market confidence. The August figures suggested the possibility of a reversal of the inflation rate and consumer prices.

On questions about the complexity of the inflation target mechanisms within the consultation bands, the staff faced a difficult situation, the staff representative confirmed. The target for 2001 was 4 percent and the authorities had stated that the upper band would be 2 percentage points higher, raising the inflation target for 2001 to 6 percent. The staff shared the view of the central bank, that due to external shocks, inflation would reach about 6.5 percent by the end of 2001. A difficult situation would arise, if the same inflation target with the same consultation bands was maintained under the new arrangement because in the worsening environment that target was clearly not attainable. In such a case, the credibility of the consultation band mechanism would be undermined. On the other hand, the authorities had officially stated that they did not want to change the inflation target for 2001 and 2002, because they had tried to avoid giving the impression that the BCB was abandoning inflation targeting.

On the questions regarding the restructuring of the federal bank, there were two types of actions that the authorities were currently contemplating, the staff representative explained. First, there was the issue of incorporating measures to improve corporate governance, including the separation of asset management and commercial banking operations, attracting better management, which would involve higher salaries for the management, and imposing the same type of internal control standards that had been imposed in the private banking sector. Second, measures had been implemented to increase the profitability of the bank. The pricing of all operations of the bank were done at market rates and without subsidies (the latter were now fully reflected in the budget). Moreover, the authorities' plan to increase the sales of the shares of the Banco de Brazil in the new stock market required higher corporate requirements from the companies listed in that market.

On diversifying energy sources, the amount of energy produced by hydroelectricity in Brazil was more than 90 percent, the staff representative said. The best strategy would be to diversify the sources of energy in the country. Part of the problem, as some Directors noted, was the lack of investment. At the same time, the authorities were trying to diversify some of the sources of energy by using thermoelectric plants. That investment program had been described in the staff paper. The authorities also used increasingly minor sources of energy, like wind generation and coal generation processes. There were also some nuclear plants in Brazil, which were very expensive. The authorities were currently considering expanding one nuclear plant near the state of Rio de Janeiro.

The Deputy Director of the Policy Development and Review Department (Mr. Allen) clarified that, on Mr. Palei's question about access under the SRF and Stand-By Arrangements, if the balance of payments problem justified access under the SRF, then any access above the standard access limit should also be normally provided through the SRF, unless there was reason to require the use of credit tranche resources beyond the access limit, as in the case of Argentina.

Mr. Kelkar asked whether the SRF share of total resources was comparatively high because the Stand-By Arrangement was precautionary. If the Brazilian authorities were to draw those resources, perhaps a larger Stand-By Arrangement would be more prudent, rather than asking the authorities to draw more resources under the SRF.

The Deputy Director of the Policy Development and Review Department (Mr. Allen) explained that the SRF was designed to deal with short-term financing needs. Repurchases were expected to be made quickly, thus the rather short repayment period. It was the staff's view that the SRF was the appropriate facility to address the kind of financing problem the Brazilian authorities were facing. There was no need for an access with a longer repayment period as provided by drawing under the credit tranches.

Mr. Portugal made the following concluding statement:

> Let me start by repeating the words of appreciation to the staff and management that I included in my statement. Staff has been very dedicated to this program and Mr. Perez and his team have put in a lot of hard work,

beyond what the call of duty would require. So, I really want to thank them very much for that.

I would also like to thank my Board colleagues for their support to our request for this new Stand-By Arrangement, for the kind words that they expressed, recognizing the commitment and the ownership of my authorities on this program, and for their generally positive assessment of the program.

I took note of the various comments and suggestions that have been made. I will pass them on to my authorities in Brasilia. My authorities do pay great attention to the kind of advice the Board provides, both the finance minister and the governor of the central bank read all the statements. I have to report in detail what each Director has said. So, we value this discussion very much, and everyone expressing an opinion.

We hope that your press statement will give a strong and positive message of confidence to Brazil and to the policies we are trying to implement. I think a positive signal is very important for us at this moment of wavering market confidence due to the global economic environment, which was already unfavorable before the tragic events in the United States and has become even more unfavorable after September 11, 2001.

I think the staff has responded very well to the various questions that were raised by Directors. I already intervened before on fiscal issues and the question of debt dynamics and debt composition. Let me make a few points on some other topics.

The Board discussed the interventions by the Brazilian authorities in the foreign exchange markets. I reassure the Board that the policies we currently pursue remain the same. We have a free floating exchange rate regime and do not target any particular level of the exchange rate. I think our past track record and the simple fact that we allowed the exchange rate to depreciate by 25 percent this year—which clearly does not reflect fundamentals—shows that. However, this does not mean that we will never intervene in the foreign exchange market. I think no country does that. The Brazilian authorities believe that intervening is an option for exceptional circumstances, to counter disorderly market conditions. Of course, it is very difficult to define precisely what exceptional circumstances are. If we were thinking what exceptional circumstances were some time ago, we would possibly be more focused on developments on the continent. We do not know what is going to happen, judging from the current stage of market unsettlement, but we are not going to use the Fund money to intervene, as mentioned here. The reason is the discretion the authorities have on defining what exceptional circumstances are. Brazil also has a NIR floor, which is very high. It is more than all the money that the Fund could disburse to us. So it is impossible that we would use Fund resources under the program to intervene, because the NIR floor is higher than the access under the Fund facility. The Fund money will go into the gross reserves and not the NIR.

On inflation, a few Directors expressed the concern that next year's 3.5 percent target would not be achieved due to the pass through of the exchange rate depreciation. I believe, as Mr. Perez explained, the recent estimate for the pass through is 15 percent. The recent increases in real interest rates since March have already started to have an impact through the aggregate demand channel, both directly and indirectly. And, this has been important. I think the pass through can be substantially lower if the widening of the output gap is factored in. This is consistent with the latest evidence on inflation, as the staff pointed out.

The monetary authorities are confident that the current policy stance is adequate to bring inflation down to the target level in 2002. We have a system that we trust. We developed it with a lot of assistance, both from the British and the Canadian central bank. Given the changing environment, the central bank will have to continue to act preemptively and to adjust the rates on a forward-looking basis, as I mentioned in my statement.

On external vulnerability, it has been pointed out by Directors that Brazil has a large and persistent current account deficit of about 5 percent of GDP, which has not been reduced, and that Brazil needs to run a trade surplus to reduce debt vulnerability. I agree with those arguments. However, it could be misleading to look at the current account deficit just in terms of percentage of GDP in the current situation of substantial depreciation, because that tends to increase that percentage. If we look at the current account in absolute dollar numbers, we will see some improvement there. It was 33 billion in 1998 and came down to 26 billion. By the way, this same argument applies to the share of dollar-indexed debt in total debt. The increase of the share of dollar-indexed debt does not mean that the absolute amount of dollar-indexed debt in dollars is increasing. The share increased because of the devaluation effects.

I do agree with Directors that debt service is high in relation to exports, and that Brazil needs to run a surplus. With the substantial depreciation of the exchange rate this trend is going to reverse. Staff already projects a trade surplus of 2 billion for 2002. As I mentioned in my statement, Brazil implemented measures to liberalize trade. The average import tariff was reduced from 32 percent to 13 percent, while imports have doubled, both in dollar terms and as a percentage of GDP. On the other hand, trade liberalization also depends on other countries liberalizing. However, I am confident that the current account is sustainable over the medium term.

The Acting Chair made the following summing up:

Executive Directors praised the authorities for the progress made under the Stand-By Arrangement approved in December 1998, noting in particular the significant improvement in the fiscal accounts and the successful transition to a floating exchange rate regime, which was achieved without generating excessive price pressures. This progress has continued in 2001, with the March and June fiscal targets met under the Stand-By Arrangement by wide margins.

Directors noted, however, that, despite this good performance, the deterioration of the external environment in recent months, a domestic energy crisis, and uncertainties in the run up to next year's presidential elections had put substantial pressure on financial variables, with the real depreciating and bond spreads widening. These factors had begun to impact the real economy, with output growth slowing significantly in the second quarter of the year. In this context, they praised the authorities' commitment to continued fiscal consolidation and further structural reform. Successful implementation of these policies, along with the maintenance of the floating exchange rate regime and the inflation targeting framework, should promote continued growth and stability.

Directors welcomed the fiscal consolidation effort envisaged in the program. Given the large share of public debt that is at floating rates or is indexed to the exchange rate, Directors recognized that some worsening of the debt-to-GDP ratio was likely this year. Meeting the fiscal deficit targets for 2001 and 2002, they noted, was therefore key to ensuring that the debt dynamics would remain under control in the near term, and that the debt-to-GDP ratio would decline over the medium term. Directors urged the authorities to persevere with efforts to reduce the share of floating rate and exchange rate-indexed instruments in the public debt stock as market conditions allow. They also noted that the scope for fiscal adjustment is constrained by the relatively inflexible structure of public expenditure, and encouraged the authorities to seek methods to increase the flexibility of the fiscal accounts, in particular by reducing the heavy reliance on revenue earmarking. Several Directors suggested that emphasis be placed on restraining current outlays, while maintaining capital spending in the interest of increasing long-term productivity growth. Given the uncertain debt dynamics, a few Directors recommended that the authorities consider accelerating fiscal consolidation beyond the levels contemplated in the program, in particular because of the rise in overall public sector borrowing requirement.

Recognizing that the shocks experienced this year—including significant adjustments to administered prices—have had a significant impact on inflation, Directors agreed with the tight monetary policy pursued by the central bank within the inflation targeting framework, which has sought to limit the extent to which the exchange rate depreciation and administered price adjustments were passed through to other prices. A few Directors expressed hope that an improved external environment and some real appreciation of the real would create scope for some monetary easing in the near future, particularly if domestic demand growth remains weak. However, the authorities would need to continue to monitor inflation prospects carefully, and stand ready to tighten policy further, if necessary, to ensure that inflation follows the declining path in the authorities' program. A few Directors underlined the merits of a good communication strategy in this regard.

Directors observed the authorities' commitment not to intervene in foreign exchange markets beyond the levels already announced, except in extraordinary circumstances. They noted that Brazil's floating exchange rate regime provides an important instrument to allow the economy to respond to shocks, and commended the authorities for largely allowing the exchange rate to fulfill this role. While intervening within its agreed bounds, Directors urged the authorities to continue to avoid targeting any particular level for the exchange rate. Considering the hedge against exchange rate risk provided through the issuance of dollar-denominated debt, some Directors considered that the reserves set aside for intervention might better be used to pay down debt. Some Directors also expressed some uneasiness about a policy mix that combined limited, preannounced, intervention in the foreign exchange market with inflation targeting. Directors also encouraged the authorities to continue to deepen regional trade, especially with MERCOSUR, and to further their trade liberalization efforts in general.

Directors encouraged the authorities to make renewed progress on the structural reform agenda, including in the energy sector during the program period. They noted that proposed reforms would in particular further ensure the sustainability of the fiscal accounts and increase the efficiency of the financial system. Directors welcomed plans to consider reforms to the system of indirect taxation, including elimination of distortionary taxes. They also welcomed the steps that had already been implemented to restructure the federal banks. In this respect, they urged the authorities to carry out their plans to improve the management of federal banks, and to ensure that all quasi-fiscal activities conducted through these banks be reflected in the budget. Directors also welcomed the authorities' decision to undertake a Financial Sector Assessment Program. They encouraged the authorities to persevere with their privatization program.

Directors stated that full and firm implementation of the macroeconomic and structural policies in the proposed program should be consistent with the achievement of the program objectives. They noted, however, that the international environment remains uncertain. Therefore, they welcomed the authorities' commitment to stand ready to adjust the macroeconomic policy stance in a flexible and timely manner, if needed.

Some Directors encouraged the authorities to consider publication of the staff report.

The Executive Board took the following decision:

1. The Government of Brazil has requested a Stand-By Arrangement for a period of fifteen months in an amount equivalent to SDR 12,144.40 million.

2. The Fund approves the Stand-By Arrangement set forth in EBS/01/149.

3. The Fund waives the limitation of Article V, Section 3(b)(iii) of the Articles of Agreement.

4. The Fund notes the cancellation of the Stand-By Arrangement for Brazil approved on December 2, 1998.

Decision No. 12571-(01/95), adopted
September 14, 2001

2. TURKMENISTAN—DATA PROVISION TO FUND

The Executive Directors considered a staff paper on issues in data provision to the Fund with respect to Turkmenistan (EBS/01/129, 8/3/01).

Mr. Cippà submitted the following statement:

The staff report before us today describes in detail issues of data provision to the Fund by Turkmenistan. Based on problems in data provision in the context of Fund surveillance in the recent past—it is important to note that Turkmenistan is the only CIS country that has never drawn on Fund resources—staff believes that Turkmenistan is in breach of its obligations under Article VIII, Section 5 (a).

My Turkmen authorities are fully aware of the importance of providing comprehensive and timely information to the Fund and have reiterated at several occasions the high value they attribute to the cooperation with the IMF and other international financial organizations. They are extremely concerned by staff's very serious allegation regarding the failure to fulfill their data obligations. This would be the first case of a breach of obligations under Article VIII, Section 5 (a) since Czechoslovakia in 1956, in which, by the way, political considerations played a larger role than data considerations. Based on the following comments, my Turkmen authorities sincerely hope that the Executive Board will refrain from accepting the proposed decision.

In the paper, staff points out the significant achievements of Turkmenistan in improving data compilation and reporting to the Fund between 1993 and 1999. To a large extent, these results were obtained thanks to technical assistance from the Fund. My Turkmen authorities fully recognize the importance of such assistance, an important element of which was also the presence of a Fund resident representative. Unfortunately, in September of 1999 management decided not to replace the outgoing resident representative.

In the recent past, some problems have occurred in the data provision to the Fund. The Turkmen authorities fully acknowledge these problems and would like to stress that they stem exclusively from temporary technical difficulties. These difficulties have been caused mainly by the reorganization of a number of ministries and agencies, which necessitated changes in their systems of the collection and processing of statistical information. The authorities are working intensively on implementing these changes in order to re-establish the tradition of providing comprehensive, accurate and timely data to the Fund, thereby allowing the Fund to perform its surveillance mandate. The Turkmen authorities are interested in the provision of such information, particularly in a period of significant economic and social successes. On this basis, my Turkmen authorities do not agree with staff's line of reasoning, which argues that Turkmenistan is in breach of obligations under Article VIII. Section 5 (a), because it has demonstrated the technical feasibility of providing adequate data by its data provision in earlier years. Technical difficulties have temporarily hindered the authorities' ability to provide adequate data. As the staff points out, Turkmenistan has been providing data in various areas as it has become available over the past year.

The Turkmen authorities wish to reiterate their commitment to resuming the full provision of adequate data for surveillance purposes in the near future and hope that the Executive Board can show understanding for the temporary difficulties they are facing.

A more general issue is the one regarding the timing of the proposed decision. I have a great difficulty in understanding staff's motivation for bringing this case to the Board at this point in time. The Board has recognized the need to consider more generally the issues related to data provision to the Fund for surveillance and in previous discussions, questions have been raised as to the appropriateness of the data categories listed in Article VIII, Section 5 (a). Because of these problems, we have scheduled a discussion for February 2002. In my view, the discussion of the issues in the specific case of Turkmenistan, which touches exactly upon the general issues, preempts our planned discussion and creates a problematic precedent. In the draft decision, staff is mandating Turkmenistan to provide a specific set of core statistical indicators that goes well beyond the information required under Article VIII, Section 5 (a). The decision on which additional information should be required under this Article, must be discussed independently of specific cases.

As I stated at the outset, the decision before us is nearly unprecedented. Given our knowledge of the existing difficulties in many member countries in providing adequate data to the Fund for surveillance purposes, I am very concerned by the signal we are sending to the Turkmen authorities with regard to the principle of evenhanded treatment of Fund members. In this context, it is important to remind the Board of the existing sensitivities in Turkmenistan following past Board decisions supporting Fund programs for certain debtor countries, notwithstanding their large official payment arrears vis-à-vis Turkmenistan.

In my view, the best way to proceed would be to come back to the specific case of Turkmenistan, if still warranted, after the general discussion on data provision for surveillance purposes. Deciding today, would unduly and unnecessarily strain the relationship between the Fund and Turkmenistan.

Extending his remarks, Mr. Cippà stressed that the key issue for the current Board discussion was not whether Turkmenistan should provide the required data, as the Board clearly agreed on the need for the authorities to provide the data, and had been urging the authorities to do so for some time. The issue at stake was whether Turkmenistan could be declared at the current stage to be in breach of their obligations under Article VIII, Section 5. A fundamental condition for the breach to occur was that the authorities should be in a position to provide the data. The authorities claimed that temporary difficulties had prevented them from providing data. They were currently working to overcome those difficulties, and the recent provision of data on international trade proved their commitment to provide the required data. It would be inappropriate to take the important decision of declaring a country in breach of Article VIII—something that had not happened since 1952—under the circumstances described in his preliminary statement. Postponing the discussion for some months to give the authorities the opportunity to prove that they were serious in their commitment would be the best course of action under the current circumstances.

There were also concerns with the timing of the current discussion, Mr. Cippà pointed out. A general discussion on the appropriateness of the data categories listed in Article VIII, Section 5 (a) was scheduled for February 2002. It would seem advisable to postpone the current discussion on issues of data provision by a specific country until the general discussion had taken place. The Board should decide how long such a postponement should be.

The Director of the European II Department (Mr. Odling-Smee) updated Directors on the latest developments in Turkmenistan's data provision to the Fund. A copy of the latest monthly bulletin produced by the National Institute of State Statistics and Information of Turkmenistan had been received in the Fund's office in Ashgabat a week earlier. Prior to that, the office had not been receiving the monthly bulletin since mid-2000, when regular provision of the bulletin had stopped. The bulletin included important background economic information, mostly on production in various sectors of the economy, and on total exports and imports of merchandise, with a breakdown according to countries of destination and origin through July 2001. Foreign trade data, which the authorities had failed to provide during the previous eight months, were listed under the Article VIII, Section 5 (a) data provision requirements. The proposed draft decision attached to the staff report had been revised in line with recent developments.

The second recent development had been a letter received the day before the Board meeting from the Turkmen authorities reassuring the Fund about their intention to provide the data needed by the staff to conduct the Article IV consultation, the Director continued. These included balance of payments data for the first half of 2001, data on state budget execution for the first half of 2001, and some unspecified macroeconomic indicators. However, the letter did not specify the dates when such data would be provided to the staff. In addition, the letter did not mention the provision of data on gross official reserves, net foreign assets of commercial banks, the international investment position of Turkmenistan, exchange controls, and official clearing arrangements. All these data were required under Article VIII, Section 5 (a). There was also no indication in the letter as to when the authorities would provide an update of other core statistical indicators, such as the central bank's balance sheet, reserve and broad money, and the overall government balance.

Mr. Cippà asked the staff to clarify what changes had been introduced in the revised proposed decision.

The staff representative from the European II Department (Mr. Pastor) clarified that point 3 in list A provided on page 17 of the staff report, which listed the data requirements under Article VIII, Section 5, had been deleted following the recent provision of data on foreign trade by the authorities.

Mr. Daïri made the following statement:

> Members' fulfillment of their endeavors under the Articles of Agreement to provide the Fund with the required data is a serious matter and key to achieving the Fund's mandate. We therefore thank management and staff for bringing the issue of Turkmenistan's data provision to the Fund to the attention of the Board. It is now up to the Board to discuss the issue and consider the best avenue for moving forward. In doing so, while being attentive to ensuring equal treatment of members and avoiding any weakening of members' obligations, the Board has also the prime responsibility of maintaining the cooperative spirit among the membership and being fully attentive to members' circumstances and concerns.
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> It is, indeed, the cooperative spirit, even more than the Articles of Agreement, that cements the IMF membership and enables the Fund to develop a relationship with members that goes far beyond what is provided for

in the Articles of Agreement. This is particularly true in the area of data provision where the Fund has access to a broader range of information than referred to in Article VIII, Section 5. In this context, reaching the decision that a member is breaching its obligations is a very serious matter that requires an extensive discussion in the Board.

Among the issues to be discussed are: (i) a clear presentation of precedents in this area; (ii) the circumstances facing the authorities leading to the observed slowdown in data flows; and (iii) the general relationship with the member and the possible reasons for any weakening of the member's confidence in the Fund's cooperative nature. This, of course, does not mean that there should be a link between members' rights and obligations, nor that fulfillment of obligations should be on a quid pro quo basis.

Once this discussion takes place, the Board, before reaching any decision, could ask for a new report providing all necessary information, including the member's view, or send a fact-finding mission composed of selected Executive Directors to discuss the issue with the authorities and achieve a common understanding of members' rights and obligations as well as the difficulties facing the authorities and how they plan to address them within a reasonable time frame.

At this particular juncture, we believe that any Board decision on Turkmenistan's breaching the Articles of Agreement and any language implying deadlines for the member to observe its obligations is premature and inappropriate. Moreover, as indicated by Mr. Cippà, we need to avoid any premature extension of our current understanding of policies with regard to data provision or publication until a full discussion of these issues has been carried out by the Board.

It would not help the purposes of the Fund to declare Turkmenistan breaching its obligations and to set a deadline for obtaining data. It is more important to engage Turkmenistan to cooperate with the Fund, including in assessing the stance of present and future policies that would require provision of information that is not even included in the proposed decision, such as fiscal and balance of payments projections and medium-term outlook.

Mr. Baukol made the following statement:

Turkmenistan is the fourth instance of Board discussions on a specific country case with broad policy ramifications ahead of the scheduled discussion of the relevant general policy. The four cases are the Zimbabwe arrears discussion, the Democratic Republic of Congo (DROC) arrears discussion, the amendment of transparency decision in the context of the case of Yemen, and today's discussion. We are somewhat sympathetic to the views expressed that this is not the most efficient way to proceed, particularly given the possibility of establishing precedents relevant to one case that may overly constrain our approach to the relevant general policy discussion.

Having said that, we do not agree with Mr. Cippà's suggestion to postpone today's discussion, and we strongly support the staff's recommendation to find Turkmenistan in breach of its obligations under the policies currently guiding these decisions. Turkmenistan clearly does not comply with the existing rules under Article VIII. Provision of adequate data is basic to the Fund's surveillance function—a function that has become all the more important in the context of our crisis prevention efforts. While Turkmenistan is not a systemically-important country, lack of action by the Fund in this instance would set a disturbing precedent for the compliance by members of their obligations to the Fund.

It is worth noting that Turkmenistan's noncooperative stance is not limited to its relationship with the Fund. The information in Box 1 makes clear that all international financial institutions with which Turkmenistan interacts have found their operations hampered by inadequate data provision. We understand that the Bank's staff has recently returned from a mission to discuss data provision issues, and we would appreciate an update by the staff representative of the World Bank on this matter.

While Mr. Cippà correctly notes that Turkmenistan has never drawn on Fund resources in the context of a funded arrangement, the authorities have benefited from technical assistance provided by the Fund and other agencies aimed at improving their capacity to gather the required data. They have utilized this assistance effectively and demonstrated their ability to report the required data in the past. We would note that the technical difficulties and the withdrawal of the Fund's resident representative that Mr. Cippà has referred to in his preliminary statement have not featured in previous explanations to the staff for the failure to provide data. Clarification from the staff on this matter would be appreciated.

The authorities have been repeatedly informed by the staff and management of the risks that curtailing data provision to the Fund implied for their position in the Fund. Thus, today's proposed decision should not be viewed as a surprising or precipitous step. Indeed, we wonder why it has taken so long to bring this proposed decision to the Board. We are also concerned about two specific aspects of the proposed decision.

First, with respect to the proposed 90-day period allowed for compliance with these obligations, we understand from staff that this period is completely notional and not dictated by existing policies on nonreporting. In our view, 90 days is excessively long and unnecessary in this case, given the authorities' demonstrated capacity to provide the data. Indeed, even a 30-day period strikes us as generous, but perhaps some additional time is warranted for the authorities to overcome their supposed temporary technical difficulties and to respond to the new legal obligation that this decision will impose. In any event, we would advise against viewing any period of time for compliance established in this case as a guideline to be enshrined in our general policy. Unlike Turkmenistan, other countries that may actually face capacity constraints on their ability to provide data could require more time to comply with data requirements.

The second aspect of the proposed decision that I would like to comment on is the staff's recommendation to publish its findings along with the text of the Board decision. We strongly support this proposal, which is in line with our policy of publicizing findings on misreporting. We hope this will feature in the recommendations to the Board for the general policy discussion to strengthen the application of Article VIII, Section 5.

We note an important distinction relative to misreporting that merits consideration in this case, as well as in our general policy discussion. Data provision is a continuous obligation, different from an obligation to report on specific economic outcomes within a specified time period as a program-related commitment. This raises questions about how to handle both improved compliance and recidivism. Some thought will be needed on how we publicly acknowledge a country's renewed cooperation after a breach in its data provision obligations, as well as the appropriate way to deal with a country that temporarily strengthens data provision and then falls back into a noncooperative mode. All these things should be taken into account in the general discussion.

Finally, I would like to emphasize the somewhat awkward position in which we find ourselves today by the presentation of a country case relevant to a general policy issue when the Board discussion of that policy matter will occur relatively shortly. It seems an inefficient use of the time of the Board, management, and the staff, given the likelihood that arguments made during the discussion on this specific case today will be repeated in the general policy discussion.

Mr. Kranen made the following statement:

We have problems in supporting today's proposed decision.

I think there is no dispute between staff and the authorities that they are problems in the data provision to the Fund. Mr. Cippà clearly states in his preliminary statement and at the beginning of this discussion that the authorities fully acknowledge these problems. Furthermore, Mr. Cippà has promised that his Turkmenistan authorities are committed to resume the full provision of adequate data and have already started doing so, as Mr. Odling-Smee pointed out.

Since there is no dispute I do not see much merit in adopting a formal board decision that Turkmenistan is not reporting required data in a timely manner.

Turkmenistan has no obligations to the Fund. Turkmenistan has never drawn on Fund recourses. I really do not see any sense to make such a harsh decision today.

I would suggest that we trust the assurances of Mr. Cippà that the Turkmenistan authorities are firmly committed to fulfill its reporting requirements. Maybe, Mr. Cippà could give as a more specific perspective how much time the Turkmenistan authorities still need to do so. I would like to propose 90 days as a reasonable time frame.

In addition, the Board could decide to revisit this issue if this problem continues to persist. At the moment I do not see any reason not to believe in Mr. Cippà's assurances and cannot support the proposed decision.

Mr. Kiekens made the following statement:

Management must bring to the attention of the Board serious problems of members' compliance with their obligations under the articles of agreement.

Management was right to submit to the Board's attention of Turkmenistan's failure to provide the Fund with the information necessary for surveillance.

For the reasons explained in the staff report and after having carefully read Mr. Cippà's statement representing the views of the Turkmen authorities, I conclude that the adoption of the proposed decision would be justified.

However, as a sign of political goodwill, and in light of the Turkmen authorities' commitment to "resume a full provision of adequate data for surveillance purposes in the near future" as expressed in Mr. Cippà's statement, I propose to postpone the decision and, if necessary, to reconsider the case early January 2002. There is no reason to postpone such a decision until the Board has decided to broaden the list of data that members must provide to the Fund. Turkmenistan is in breach of its obligation under Article VIII and there is no intention to narrow the obligation under that provision, quite the contrary.

I further note Mr. Cippà's concerns about evenhanded treatment of Fund members. I urge the staff and management, and particularly the Legal and PDR Departments, to ensure adequate coordination in the application of the Fund's policies, with a view to maintain the non-discriminatory treatment of its members. The ultimate responsibility for guaranteeing equal treatment is with the Board. The Board relies on the staff and management to be informed in a comprehensive and timely manner, in order to preserve equal treatment.

Mr. Vittas made the following statement:

The deterioration in the provision of basic macroeconomic data by the Turkmen authorities to the Fund is a matter of grave concern. It has been responsible for a very long delay in the conduct of Article IV consultation discussions, has made it impossible to complete the preparations for the publication of an IFS page for Turkmenistan and, more generally, it has seriously hampered the Fund's ability to fulfill its surveillance mandate.

Like previous speakers, I am grateful to management and the staff for bringing this matter to the Board's attention and appreciate the concise, yet well documented report that the staff has prepared for today's discussion. Nevertheless, I share the feeling that it may be premature at this stage to take a decision declaring unequivocally that Turkmenistan has breached its obligations under the Articles of Agreement. There are essentially two reasons for my taking this position:

First, despite the evidence provided in the staff report, I am not entirely convinced that the failure of the authorities to provide adequate data to the Fund reflects predominantly their unwillingness to cooperate with the Fund. The alternative explanation put forward by the authorities, namely that recent problems in the provision of data to the Fund reflect organizational changes that have reduced their ability to collect the relevant information, cannot be rejected offhand. I note also that the authorities indicated that they expect these problems to be temporary and are working diligently to overcome them. In view of this, I am inclined to give them the benefit of the doubt and postpone a decision for the time being.

The second, more important, reason for which I feel that it may be premature to take a decision today is that the Board has yet to take a general decision concerning the applicability of Article VIII, Section 5. On this issue, my view is that the list of variables explicitly listed in Article VIII, Section 5 is purely indicative. It does not in any way limit either the Fund's ability to request information on other variables, not listed but deemed essential for surveillance or, more importantly, the member's obligation to provide such information, provided of course that it is available. I recognize, however, that other chairs as well as the General Counsel take a different, more restrictive, position on the interpretation of Article VIII, Section 5. This is obviously a very important policy issue that is likely to be resolved only when the Board has the opportunity to discuss the applicability of the Article on the basis of a staff paper that is still under preparation. Until then, it would not be wise to take Board decisions on individual country cases that set precedents and may prejudge how the issue will eventually be resolved.

All in all, I am prepared to go along with Mr. Cippà's request to postpone a decision at this stage. However, it should be clearly understood that the postponement is strictly temporary. At the same time, we should urge the authorities to improve their cooperation with the staff and to take all the steps that are necessary to address inadequacies in their statistical systems and resume very soon the provision of adequate and timely information to the Fund. The summing up of today's discussion could be used as a vehicle for conveying this message to the authorities in an unequivocal manner.

Mr. Lushin made the following statement:

Let me begin by saying that I'm very much concerned with the situation around data provision to the Fund by Turkmenistan. It is highly regrettable that the Article IV consultation with Turkmenistan could not be undertaken because of the shortage of data. I believe that now all the efforts should be made to ensure the resumption of the normal provision of information to the Fund by the Turkmen authorities.

To accomplish this, however, it is necessary to determine the source of the ongoing difficulties. And here the situation is not quite clear to me. The staff claims that prior provision of statistical data evidences Turkmenistan's technical feasibility to report this information in a necessary manner. This implicitly hints at the bad faith of the authorities in dealing with this issue. However, the authorities, as it is clear from Mr. Cippà's preliminary statement, claim that currently they experience temporary technical difficulties, which were the only reason for problems with data provision. At the same time, the staff paper addresses none of the difficulties mentioned by the authorities, for example, the reorganization of a number of ministries and agencies.

I am afraid that without a clear knowledge of all the facts and circumstances behind the existing situation we can make a hasty decision that would eventually make the situation even worse. Therefore, I would like to seek clarifications from the staff on the technical difficulties mentioned by Mr. Cippà, and from Mr. Cippà: when specifically will the authorities be prepared to resume the full provision of adequate data to the Fund, which they seem to be strongly committed to, according to his preliminary statement?

I understand that it might be difficult right now to draw a crystal clear picture. But if there is a reasonable possibility that the authorities may in fact be experiencing technical difficulties, I think it would make sense to give them a chance to return on track in a reasonably short and predetermined period of time. Information provided today by Mr. Odling-Smee may indicate that they might have started to do just that. However, if they fail to comply, then our hands will be free to initiate formal procedures in line with the one proposed in the staff paper. In other words, I propose for the very last time to give the Turkmen authorities the benefit of the doubt on the basis of their firm assurances of forthcoming compliance.

Mr. Le Gal made the following statement:

I am somewhat uncomfortable with the procedure followed in this case. I share the points made by different chairs about by the timing of the decision, as it does not appear appropriate to ask the Board to make a decision on a specific case before a more general policy discussion.

I consider that the staff has made a clear case in support of the recommendation that Turkmenistan is in breach of its obligation under the Article VIII. The difficulties are not new. The authorities, as well as the Board, have been informed of these problems regularly, and furthermore, Box 1 in the staff report shows clearly that the Fund is not the only institution that has difficulties in obtaining adequate data from the Turkmen authorities. Therefore, I can go along with the staff's proposal.

Mr. Low made the following statement:

When we read the staff report, we believed that staff have sufficient grounds to determine that Turkmenistan is in breach of its obligations under Article VIII Section 5 because of its failure to provide adequate and complete macro economic data to the Fund to enable staff to undertake effective surveillance of Turkmenistan. Staff appears justified to conclude that the Turkmen authorities have the capacity to compile the required data since they had provided the Fund with such data in the past.

However, when we read Mr. Cippà's preliminary statement, there seems to be a very different perspective to the issue which staff had omitted in their submission to the Board. According to Mr. Cippà, the Turkmen authorities are facing technical difficulties caused mainly by the reorganization of a number of ministries and agencies that have necessitated changes to the systems of collecting and processing such statistical information. In the meantime, the authorities have been making their best efforts to submit the required information as and when they become available.

We are disturbed by the discrepancies in the explanations provided in the staff report and Mr. Cippà's preliminary statement. We hope staff can provide their reasons for not reporting the problems faced by the authorities as stated in Mr. Cippà's preliminary statement. Otherwise, we wonder if this would be considered a case of misreporting by staff. We sincerely hope this is not the case. We are also seriously concerned with staff's insinuation in

> paragraph 9 of the report that the authorities had refused to cooperate with the Fund because of their displeasure with the Fund on its handling of repayment of debt arrears by Georgia and Ukraine to Turkmenistan. We also sincerely hope this is not what staff intended by this paragraph.
>
> On the basis that the authorities are indeed encountering technical difficulties in providing the necessary data to the Fund, and given the authorities commitment to resume the provision of adequate data to the Fund for surveillance purposes in the near future, we are of the view that the proposed decision to find Turkmenistan to be in breach of Article VIII Section 5 unwarranted and harsh. It does not bode well for the image of the Fund as a cooperative institution which seeks to assist rather than penalize members which are in difficulties. As such, we cannot support the proposed decision. On the contrary, since the Turkmen authorities are encountering technical difficulties (here, we share the views of other Directors that the authorities should be given the benefit of the doubt), we wonder if further technical assistance from the Fund is warranted to assist the Turkmen authorities to overcome such technical difficulties as soon as possible.

The Acting Chair (Mr. Aninat) quoted an excerpt from a recent letter from the Deputy Chairman of the Cabinet of Ministers of Turkmenistan which suggested that there was no distrust in the authorities' attitude toward the Fund and its staff: "I express my gratefulness to your staff and you personally for the assistance provided by the Fund to the process of socioeconomic reforms in our country. The dialogue between Turkmenistan and the Fund should be fruitful, particularly in respect to the recommendations of the Fund, which will be taken into account when developing the directions of economic policy."

Mr. Yakusha made the following statement:

> Like other Directors, I am somewhat skeptical about the timeliness of this discussion. On a procedural note, it would have been advisable to distribute the recent communications from the authorities to Board members before discussing this important matter.
>
> I strongly believe that all member countries should fulfill their obligations under the Articles of Agreement, and that countries should do all they can to provide the data required for adequate surveillance by the Fund. Therefore, I believe the Turkmen authorities should make a strong effort to provide the data that the staff is asking for, and to do it in a more timely manner than in the last two years. Moreover, I strongly believe that getting back into the framework of cooperation with the Fund is in the best interests of Turkmenistan. While it is true that Turkmenistan has not drawn on Fund resources, it is also true that its economy and external position depend strongly on demand for energy. Turkmenistan is not among the most stable states in the region, and it is unlikely that it will become more stable soon.

> Given these risks, drifting further away from the international community may not be a sustainable strategy for the authorities.
>
> Having said that, I believe we should wait before publicly taking a hard line toward the country. I acknowledge the technical difficulties in data collection highlighted in Mr. Cippà's statement. We are also aware of the emigration of skilled workers from the country that has been taking place. On the other hand, it is the responsibility of the authorities to address that challenge, and it appears that they have not paid sufficient attention to these problems thus far. The authorities should receive a strong warning from the Board, but they should also be given another opportunity to address the existing problems within a strict but feasible deadline. The message they should receive from the Board is a warning that they are late in meeting their obligations under the Articles of Agreement. This would be a good compromise between the two positions expressed so far.
>
> I also assume there are many more countries with similar arrears in data provision to the Fund. The arrears in the provision of data required in Article VIII, Section 5 do not seem to be exceptionally large—judging from the information provided in Table 12 on page 12 of the staff report, most arrears apply only to the last five to six months—although Turkmenistan also fails to provide other crucial data generally provided by the rest of members. I would need to review a list of arrears in data provision by other Fund members to assess if the equality of treatment is being guaranteed in this particular case. I hope the staff can prepare the relevant note for the Board not only for the next discussion on Turkmenistan—as Turkmenistan's performance in providing data to the Fund should be subject to continuous review by the Board—but also for the general discussion on Article VIII, Section 5.

Mr. Collins asked the staff representative from the Legal Department to comment on the possibility that a country that justified the failure to provide data on the basis of technical difficulties might have deliberately failed to take the steps needed to put itself in a position to be technically able to produce those data. That was a key issue to ensure the equality of treatment of Fund members. Another issue for contention in the case currently under consideration was the legal basis for the request in list B of the proposed decision to provide additional data not explicitly included in the data requirements in Article VIII, Section 5. Could the list in Article VIII, Section 5 (a) be interpreted only as minimum requirements with the implication that additional items could be required if deemed necessary, or did section (c) in the article, which stated that the Fund may arrange to obtain further information with the agreement of members, provide the legal basis for such additional requirements? The latter option would raise the question of whether an agreement had been reached with the Turkmen authorities on the provision of data in list B of the proposed decision.

Mr. Lehmussaari acknowledged the importance of the staff's concerns in the case of Turkmenistan, and more generally of the issue of data provision. The authorities' view, as stated in Mr. Cippà's statement, was that temporary technical difficulties had prevented them from fulfilling their obligations of data provision to the Fund. Like Mr. Kiekens, he felt that it would be appropriate to give the authorities the benefit of the doubt on this matter.

The Director of the European II Department (Mr. Odling–Smee), in response to the question about the nature of the technical difficulties alleged by the authorities, stated that the staff had not detected such difficulties during the 16 months it had spent negotiating with the authorities prior to the current Board discussion nor had the authorities expressed the view that data provision was effected by technical difficulties. The staff knew about the introduction of changes in the organization of ministries, but was unaware that such changes had had any effect on the compilation and collection of statistical data. Moreover, the central bank and the foreign economic relations agency—which were the agencies that had provided the staff with monetary, balance of payments, and external debt data in the past—did not appear to have been directly affected by those reorganizations. The letter from the authorities received the day before the meeting—quoted by the Acting Chair—did not mention any technical difficulties either. Therefore, while Mr. Cippà's reporting on behalf of the Turkmen authorities deserved all due respect, the staff did not believe that the temporary difficulties alleged by the authorities could readily explain the failure to provide data over such a long period of time.

Regarding the authorities' offer—communicated through Mr. Cippà—to fully provide adequate data for surveillance purposes in the near future, Directors would have to assess the reliability of such offers, the Director observed. Many Directors had rightly seen a ray of hope in those offers, and were proposing to allow the authorities more time to meet their renewed commitments. The staff could only note that similar offers had previously been made with some frequency, but had consistently remained unfulfilled. In this regard, perhaps the staff report should have provided Directors with more detail on the promises received from the authorities in the past. The staff report made reference to the six letters sent to the authorities between August 2000 and February 2001, which had all been followed by replies promising full and prompt provision of data. Some of those replies provided lists of the data that would be provided, and in some cases the dates by which they would be provided were also specified. Those promises had not been fully honored. The letter received the day before the meeting also promised data, but it was vague in terms of specific dates and coverage of the data to be provided.

Regarding Mr. Baukol's concern that the 90-day period for the provision of data suggested in the proposed decision might be excessively long, the Director considered that the authorities would certainly have sufficient time to provide the required data during that period—especially as his own view was that the data were already available. The period was likely to be sufficient even when the organizational difficulties recently alleged by the authorities were taken into account. On the other hand, Mr. Cippà had referred in his opening remarks to the need for time to provide those data, and, judging from interventions by other Directors, the Board appeared to lean toward allowing the authorities a reasonably long time to provide the data. Therefore, the 90-day period suggested by the staff appeared appropriate.

The General Counsel (Mr. Gianviti), in response to Mr. Collins's question on the need to differentiate between inability and unwillingness to provide data, reminded Directors that an extensive discussion of this issue had been provided in a prior staff report on Article VIII, Section 5. In particular, the point had been made in that report that capacity was not a static concept, as it included the obligation for countries which did not currently have the required capacity to make every effort to develop that capacity. Therefore, the Board should consider not only the country's current capacity to provide data, but also its willingness to improve its capacity in order to be in a position to provide that data.

On the second question raised by Mr. Collins, which referred to the basis for the request to provide additional data in list B of the proposed decision, the General Counsel clarified that Article VIII, Section 5 (a) allowed the Executive Board to require additional data to the items explicitly listed under that section. Article VIII, 5 (c), also mentioned by Mr. Collins, referred to a totally different issue.

It should also be noted that Turkmenistan was not the first instance of an application of Article VIII, Section 5 since the case of Czechoslovakia, the General Counsel said. Article VIII, Section 5 was applicable—in addition to the standard guidelines on misreporting—in cases of misreporting where the country had the capacity to provide information but failed to provide it. Article VIII, Section 5 had been invoked on several occasions and the Managing Director had filed several reports with the Executive Board in that context. However, all such instances since the case of Czechoslovakia had involved use of Fund resources, which meant that Turkmenistan was only the first case after Czechoslovakia where Article VIII, Section 5 had been invoked in the context of Fund surveillance.

Mr. Daïri disagreed with the assimilation made by the General Counsel between cases of misreporting and Turkmenistan's case. While there were issues of data provision in cases of misreporting, in the case of Turkmenistan there was only an issue of data provision.

The General Counsel (Mr. Gianviti) clarified that his point was that sanctions under Article VIII, Section 5 had been taken on several occasions in the context of use of Fund resources, even if the issue of data provision had arisen as a result of misreporting in those cases. Two types of actions could be taken in cases of misreporting in the context of use of Fund resources: remedies under the guidelines of misreporting, and sanctions under Article VIII, Section 5.

As Mr. Kiekens had said, the ultimate responsibility for the uniformity of treatment of members lay with the Board, the General Counsel stressed. When adopting decisions on individual cases, the Board was sending signals to members as to what kind of standards they could expect from the Board, as well as indicating to management and the staff how the provisions of the Articles should be implemented. Therefore, it was up to the Board to decide whether a more lenient or strict standard should be applied in judging the capacity of members for the provision of data. In his view, the staff had thus far taken a cautious approach, delaying referral to the Board of proposed decisions to find members in breach of their obligations of data provision to the Fund until certain about the relevant member's capacity to provide the required data. Perhaps the staff should review its approach to data provision issues if the Board considered the current approach to be excessively rigorous.

Mr. Daïri stressed that, although there had been other cases of data provision issues, those had been linked to misreporting issues in the context of use of Fund resources. Turkmenistan would only be the second case—after Czechoslovakia—of a breach of obligations under Article VIII, Section 5 (a) in the context of surveillance.

The staff representative from the Policy Development and Review Department (Mr. Fetherston) confirmed that Turkmenistan was only the second case of data provision issues in the context of surveillance, as Mr. Cippà had also indicated. On a related note, and in response to Mr. Collins's earlier question, it should be noted that the data required in list B of the proposed decision were the indicators that the Board had estimated during previous discussions on data provision to be the minimum requirements for effective surveillance.

Mr. Kiekens agreed with the comments made by the General Counsel and acknowledged the difficulty for the staff to prove intent when countries claimed to be unable to provide data to the Fund. However, the burden of proof of the authorities' unwillingness to provide data despite having the required technical capacity did not lay solely with the staff. Members had the obligation to cooperate in full faith with the staff when they faced difficulties, including through explanations of the nature of their difficulties, the measures they had taken, and the help required from the Fund to overcome those difficulties. The general need for good faith cooperation from the authorities should also be stressed in the case of Turkmenistan, as the authorities had not provided a comprehensive and convincing explanation of the difficulties that they were currently facing.

Mr. Cippà agreed with the view expressed by Mr. Collins and the General Counsel that the Board should be responsible for guaranteeing the equality of treatment of Fund members. However, it was the staff's responsibility to provide the relevant information to allow the Board to make that decision. In that regard, it would be useful if the staff could provide the list of countries delaying data provision to the Fund (as requested by Mr. Yakusha). Regarding Mr. Kiekens's point on the need for good faith cooperation between the authorities and the staff, the temporary character of the technical difficulties faced by the authorities had been highlighted in his own preliminary statement. The reorganization of a number of branches and ministries had entailed changes in the systems of collection and processing of statistical information. In that context, the position of the Board seemed to be that the authorities should be granted a period of two or three months to overcome the difficulties and provide the required data.

The staff representative from the World Bank (Mr. Rodriguez), speaking on behalf of the World Bank country director for Turkmenistan, made the following statement:

> The Bank's Board discussed a new country assistance strategy (CAS) for Turkmenistan on January 23, 2001. This CAS reflects the Bank's concern with the direction Turkmenistan's economic management is taking. The CAS clearly states that the Bank will not extend new loans to Turkmenistan until

> certain basic issues relating to economic transparency and management are addressed. These basic issues include: resolving Turkmenistan's negative pledge violation; reporting Turkmenistan's debt to the world debt reporting service; improving the performance of ongoing projects; establishing a plan to reform the foreign exchange reserve fund; and establishing a plan for disseminating the full budget each year. The assessment made at the time of the Bank's Board meeting that it would likely be extremely difficult for Turkmenistan to meet those basic conditions remains valid. Despite a note from the authorities indicating their intention to resolve those issues—including a specific promise to report the data on debt by the end of March 2001—no progress has thus far been observed.
>
> The Bank shares the Fund's concern at being unable to obtain basic economic and social information. Transparency and accountability are not side matters in the quest for development. They are essential ingredients. Most of the limited technical assistance we are currently providing Turkmenistan is, in fact, focused on helping Turkmenistan improve information availability and transparency in the areas of debt management, budget modernization, public procurement, support to the statistics agency, and the introduction of international accounting principles. However, the results obtained in these areas have also been limited. For example, the Bank has supported an international debt advisor in Turkmenistan for about a year and a half, but Turkmenistan has still not reported its external debt.
>
> In conclusion, the Bank fully shares the IMF's concerns regarding basic economic and social data availability and supports bringing this to the urgent attention of Turkmenistan's senior leadership. Further, the World Bank will pay close attention to the response of Turkmenistan and will take that into account as it considers its own future work program in Turkmenistan.

Mr. Cippà stressed that the current discussion was on data collection and not on the general economic policies of Turkmenistan. Also, the failure of the authorities to provide data to the Bank was consistent with the technical difficulties reported by the authorities, as one would expect such difficulties to hinder data provision both to the Fund and the Bank.

Mr. Baukol observed that, judging from the comments by the staff representatives of the Fund and the Bank, it was clear that the Turkmen authorities had failed repeatedly and seriously to undertake their obligations, not only to provide data, but also to provide an explanation for the failure to provide the data. The fact that the authorities had only reported the existence of technical difficulties through Mr. Cippà's preliminary statement for the current discussion was puzzling. The authorities were not to be trusted on the issue currently under consideration, and it would not be appropriate to give them the benefit of the doubt, as a number of Directors had suggested. Other international financial institutions, and particularly the World Bank, had experienced great difficulties in dealing with Turkmenistan and little result had been obtained from their missions to the country in recent years.

Mr. Kranen pointed to the need for caution in questioning the trustworthiness of national authorities that had voluntarily opted to be members of the Fund. While the Director of the European II Department's comments that he had been informed about Turkmenistan's technical difficulties for the first time the day before the Board meeting were certainly a cause for concern, the explanations provided by Mr. Cippà on behalf of his authorities should not be disregarded.

Mr. Cippà was surprised with Mr. Baukol's comment that he did not trust the Turkmen authorities. Perhaps a more a constructive approach would be needed to allow for a meaningful Board discussion.

Mr. Daïri agreed with Mr. Cippà on the need to refrain from expressing doubts about the authorities' intentions at the current juncture. Technical difficulties were mentioned on several occasions in pages 9 and 10 of the staff report. The authorities had told the staff that balance of payments data had not been finalized, and that external debt data could not be provided to the Fund owing to existing inadequacies in the systems of collection. In the authorities' view, the data available at that time were not suitable for accurate economic analysis.

Mr. Baukol clarified that his view on the issues of data provision to the Fund in Turkmenistan was that technical difficulties were not the root cause of the problem, and that the authorities would be able to provide the required data immediately if they decided to do so.

Mr. Charleton made the following statement:

> We can fully understand the staff's frustration in dealing with Turkmenistan. We have worked hard and patiently on this case, and some of us are very familiar with it. Mr. Cippà's reference in his preliminary statement to the failure to replace the outgoing Fund resident representative since September 1999 does not justify the uncooperative stance taken by the authorities in the issue of data provision to the Fund. As Mr. Kiekens said, finding the authorities in breach of their obligations would be fully justified.
>
> The existence of technical difficulties alleged in Mr. Cippà's statement is difficult to prove or disprove. I am somewhat skeptical about these technical difficulties, especially as Mr. Odling-Smee has pointed out that the authorities have not previously referred to these difficulties to justify their failure to provide the data. This also explains the lack of references to such difficulties in the staff report.
>
> Mr. Odling-Smee has indicated at the beginning of the Board discussion that the authorities have provided some of the data required and have promised to provide additional data. Perhaps the saying that "justice should be tempered with mercy" would be applicable in this case. In this regard, the Board should probably be patient and consent to Mr. Cippà's plea

for one last chance, even if doubts remain regarding the authorities' attitude. While I also agree that it would be preferable to have the discussion on Turkmenistan once the general discussion on Article VIII, Section 5 has taken place, the date of February 2002 scheduled for the general discussion implies that the discussion on Turkmenistan would be excessively delayed if we were to wait for the general discussion. Nevertheless, the staff has been right in bringing the issue of data provision in Turkmenistan to the Board, and it is now up to the Board to decide when the possible breach of obligations should be discussed and declared. For the moment, I support postponing the decision.

Mr. Collins made the following statement:

I join those Directors who consider that it would have been more appropriate to have the discussion on Turkmenistan after having the general policy discussion on data provision issues to the Fund. A formal timetable for dealing with these cases, which will be a likely outcome of the general decision, would eliminate the risk of arbitrariness that we face when addressing the issue of data provision in the case of Turkmenistan. This timetable would be similar to the one that is already available for cases of arrears, which is very specific, with a list of clear steps and deadlines. The lack of a formal timetable for data provision issues makes the declaration of ineligibility to use Fund resources on the basis of data provision issues rather complicated.

Another point that is likely to come up in the staff paper to be prepared for the general discussion is the list of core statistical indicators required for surveillance purposes. As the General Counsel has indicated, Article VIII, Section 5 (a) allows the Board to require additional data to the items explicitly listed under that section. While I believe that the data requirements in list B of the proposed decision are probably adequate, these specific requirements should be endorsed by reaching a consensus at the Board on their adequacy if they are to reach a similar status to those explicitly listed under Article VIII, Section 5 (a). As regards publication, the issues for clarification identified in Mr. Baukol's statement should also be addressed in the general discussion.

Having said all this, presumably the staff have not been entirely arbitrary in bringing Turkmenistan's data provision issues to the Board at this point, barely six months before the scheduled general discussion on data provision issues. Perhaps the staff could have provided evidence of comparisons with other cases to show that this is an egregiously bad case that requires action at this time. In fact, the severity of this case seems to be confirmed just by looking at the facts provided on Turkmenistan, but it would still have been useful to have some information on other cases to conclude that the approach taken in this case is consistent with the principle of comparability of treatment of members.

On the issue of technical capacity and potential intent in the failure to provide data, after the explanations provided by the General Counsel, my judgment leans toward believing that Turkmenistan has failed to meet the test of technical incapacity. Without questioning the current existence of technical difficulties alleged in Mr. Cippà's preliminary statement, it could be argued that such difficulties have been self-imposed to a large degree. As the General Counsel has explained, technical capacity is a dynamic, rather than an absolute concept. Turkmenistan has had the technical capacity to provide the required data in the past, but that capacity appears to have deteriorated for one reason or another. In the staff's view the deterioration in capacity appears to have been deliberate, and the staff report implicitly links this to the resentment felt by the Turkmen authorities as a result of the treatment granted by the Fund to some of its debtors. On the other hand, Mr. Cippà's argument is that the deterioration in technical capacity is the neutral result of a reorganization in the institutions responsible for producing the required data. In either case, it is arguable that the Turkmen authorities have failed to prevent the deterioration in technical capacity from previously acceptable levels. Therefore, it is reasonable to go along with the legal case put forward by the staff.

As far as the content of the decision is concerned, while my preference would be to accept the decision as it currently stands, I would be prepared to drop list B of data requirements. Including list B in the decision might make the approval of the decision more problematic, as the data requirements in that list have not been established as formal requirements under Article VIII, Section 5, even if as the General Counsel has indicated, the Board has discussed the content of this list at least in one occasion in the past. This chair will certainly support the inclusion of the indicators in list B under the Article VIII requirement when the general discussion on data requirements takes place. Such considerations notwithstanding, I realize that dropping list B from the proposed decision might not help us reach a satisfactory resolution to the current discussion.

The 90-day delay deadline proposed for the provision of the required data is probably adequate. If this deadline were not met, the Managing Director would make a complaint before the Board for the declaration of ineligibility. This complaint would presumably be subject to another deadline, although we do not know exactly what this should be as we have not had a general discussion to agree on the standard procedure for data provision issues. In any case, the declaration of ineligibility would not take place immediately. The staff and Mr. Baukol think a 90-day delay for the provision of data is excessively long. Others think it is too short. I conclude it is probably about right, especially if we take into account that Turkmenistan ineligibility to use Fund resources would not be automatically declared at the end of that period, as further steps would have to follow before the declaration can be made.

> Therefore, while acknowledging the concerns of other Directors regarding the presentation of this case to the Board ahead of the general discussion, I am prepared to accept the staff's judgment that the severity of Turkmenistan's case requires immediate action, and I support the staff's proposed decision. Presumably, if the authorities continue to fail to provide the required data, we will have already held the general discussion by the time we need to decide on the declaration of ineligibility—after the 90-days granted for the provision of data plus the additional period required to consider the potential complaint by the Managing Director for a declaration of ineligibility. By that time, an agreement would already have been reached during the general discussion on further steps to be taken, for example on the issue of publication. We should not decide whether to publish the decision on Turkmenistan before we have reached a general agreement on the rules for publication in cases of data provision.
>
> To sum up, I am prepared to support the proposed decision on the understanding that the general discussion will not take place later than February 2002. Also, while my preference would be to keep list B in the proposed decision, I would be prepared to drop it if that could in any way help us reach an agreement.

The Acting Chair (Mr. Aninat) observed that, while some flexibility could be allowed on the issue of publication if Directors were reluctant to publish the decision, the implications of the option of postponing the discussion on the decision suggested by a number of Directors should be carefully considered. The proposed decision established a clear sequence of steps to be taken within a precise time schedule. However, the alternative scenario of postponing the decision would result in an open-ended situation. Perhaps Directors could consider the option of extending the period granted to the authorities for the provision of data beyond the 90-day period proposed by the staff—perhaps by another 20 or 30 days—to make sure that the complaint for a declaration of breach would only be made after the general discussion on data provision issues had taken place.

Mr. Cippà did not think that the views expressed by many Directors would be consistent with the Acting Chair's proposal to maintain in the decision the intention to make a complaint for a declaration of ineligibility of Turkmenistan to use the Fund's general resources. Many Directors were reluctant to declare the country in breach of its obligations at the current juncture, and favored the option of allowing the authorities additional time before reaching such an important decision.

Mr. Kiekens expressed his disagreement with the legal treatment currently given to the data required in list B—external public debt, central bank balance sheet, reserve and base money, broad money, external current account balance, overall government balance—which was deemed critical for the conduct of surveillance. The Legal Department's interpretation of Article VIII, Section 5 was that Turkmenistan was currently under no obligation to provide such data. Therefore, if the decision were postponed for 90 days, and in the event that the authorities continued to fail to provide the required data, the Board would not be able to find Turkmenistan in breach of its obligations to the Fund at the end of the proposed 90-day period. In that context, progress would only be achieved in the current discussion if the authorities committed to providing the data in list B, and if the Board decided that the data should be provided within the proposed 90-day period.

The General Counsel clarified that the provision of data in list A was explicitly required in Article VIII, Section 5, whereas list B was not explicitly included in the Articles of Agreement. The only question regarding list A was whether Turkmenistan was already in breach by failing to provide the data included in that list. The decision that had to be made with regard to list B was whether the Board should require Turkmenistan to provide the data included in that list within 90 days. If such a decision were to be approved, the authorities could be found to be in breach of their obligations to the Fund only at the end of that period.

Ms. Saito made the following statement:

> We take note of the comments made by Mr. Cippà in his preliminary statement, as well as of the update provided by Mr. Odling-Smee at the beginning of the meeting. Turkmenistan's data provision issues have been reported in informal briefings to the Board on numerous occasions. Considering the long-standing nature of this problem, we feel that the Board should convey the message to the authorities that we recognize the seriousness of the situation. We therefore support the proposal for the Board to adopt a decision that finds Turkmenistan to be in breach of the obligations under Article VIII, Section 5, and to call on the authorities to provide all necessary information within 90 days.
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> However, as regards the issue of publication, we feel that it would be inappropriate to publish the decision before the general policy discussion on this issue has taken place. We have not decided the procedures that should be followed or the period that would lapse before we tell the authorities what to do. We have not warned the authorities beforehand about the exact consequences of their failure to provide the information. Mr. Cippà has also made an important point about the need to refrain from creating precedents before the general discussion, as these would preempt the conclusions to be reached in that discussion.
>
> While we are not fully convinced with the explanations given by the authorities about temporary difficulties for the provision of data, we think we could give the authorities the benefit of the doubt and we find the 90-day period allowed for the provision of the data appropriate. The Board should hold the general discussion on Article VIII, Section 5—and establish the treatment that list B should receive, and the procedures that should be followed to find a member to be in breach of the obligation to provide data to the Fund—before we revisit the issue of data provision by Turkmenistan 90 days from now.

To sum up, our position is that we find Turkmenistan to be in breach of obligations under Article VIII, Section 5, and we support the decision. On the other hand, we think we should refrain from publishing the decision, the main reason being that we have not discussed the general policy. We should give the authorities the benefit of the doubt, and if I may borrow Mr. Yakusha's words, we should be careful in publicly taking a hard-line on this issue.

Mr. Hendrick made the following statement:

We support the proposed decision. We associate ourselves with the views expressed by Mr. Baukol with only one caveat. Like Ms. Saito, we think the issue of publication should wait until we have had the general discussion on Article VIII obligations. I do not have any doubt, as Mr. Cippà has said, that the authorities will be able to deliver the data in the future. In fact, I believe that the data is already available, and that what we are facing here is a problem of attitude. I could not help being amused by the comment in page 9 of the staff report stating the authorities view on data provision issues. A deputy chairman of the cabinet in charge of relations with the Fund suggested that the staff could compile all the macroeconomic information from the newspapers. Having been in charge of monetary accounts and balance of payments data in the past, I know that if the authorities have been able to deliver these data for 2000, we should not be naïve about their capability to provide the data that is currently required. Mr. Kiekens has expressed this very well when he has said that this is a breach of obligations under Article VIII, but that, as Mr. Charleton has also said, we should provide a new chance to the authorities. For this reason, I may go along with the general consensus, taking also into consideration that this is the first time that the issue is brought to the Board, even if the staff and management have been discussing the issue since mid-2000. Nevertheless, we should be all aware that we are creating a precedent by giving the authorities this new chance, and I hope that we will be equally flexible in similar cases in the future.

Mr. Al Azzaz made the following statement:

Mr. Cippà explains in his informative preliminary statement that the authorities' inability to provide adequate information on a timely basis is due to technical difficulties that reflect institutional reorganization and changes in the system of data collection and processing.

Moreover, Mr. Cippà informs us that the authorities recognize the problem and are ready to cooperate with the staff to rectify it. Indeed, an intensive effort is already evident to provide the necessary data.

Given this background, and the emphasis we place in the cooperative nature of the Fund, I can go along with Mr. Cippà's proposal.

Ms. Alcaide associated herself with the comments made by Mr. Collins.

Mr. Kudiwu made the following statement:

I join previous speakers who have favored the postponement of the decision regarding the issue of the data provision to the Fund. This is a serious issue, as recognized by Mr. Daïri and other Directors. However, I also believe that the reasons provided in Mr. Cippà's statement related to technical and temporary problems faced by the authorities need careful consideration. As long as the authorities are committed to addressing the issue of data provision, it will be more productive to give them the benefit of the doubt. I urge the authorities and the staff to continue their dialogue and to look for ways in which the Fund can help the authorities address the temporary and technical difficulties faced by the authorities.

Mrs. Farid made the following statement:

Notwithstanding the statement by Mr. Gianviti on the existence of other precedents, this seems to be the first case to be brought to the Board in the context of surveillance since the case of Czechoslovakia. In this context, we feel uncomfortable about taking the harsh decision proposed by the staff. This impression is further reinforced by the fact that the general discussion expected for early 2002 will likely establish specific procedures to address data provision issues. Therefore, we side with those who would like to give Turkmenistan another chance to resolve its difficulties before taking a decision.

Mr. Bhaskar made the following statement:

We appreciate the importance of data provision issues, especially for surveillance purposes. Therefore, we are grateful to the staff for bringing this issue to the Board. We appreciate the commitment shown by the authorities in Mr. Cippà's preliminary statement, and their willingness to make up for any shortfall in data provision. We are also aware of the need to improve the relationship between the staff and the authorities, and we feel that finding Turkmenistan to be in breach of its obligation at this stage could merely result in alienating the authorities further. In this context, we support Mr. Cippà's request that this decision should be postponed, and we suggest a delay of 90 days.

Ms. Davidson could go along with the suggestion to postpone the decision on the breach of obligations by Turkmenistan for a short period—the 90-day period suggested by Directors would be acceptable—even if, based on the facts presented to the Board, the authorities appeared to be in breach of their obligations at the current stage. Moreover, the failure to communicate at an earlier stage the technical problems that, according to Mr. Cippà's statement, had prevented the authorities from providing the required data was a matter for concern.

Ms. Patel associated herself with the views expressed by Mr. Daïri and Mr. Kranen.

Mr. Wei shared the views given in Mr. Cippà's preliminary statement. The discussion of Turkmenistan's case—if still applicable—should be delayed until the general policy discussion scheduled for February 2002 had taken place.

Mr. Baukol proposed a compromise decision in which list A would be dropped from the formal decision—to prevent the declaration of breach of obligations to the Fund under Article VIII, Section 5 at the current stage—but the authorities would continue to be urged to provide the data, including those in list B. The Managing Director would make a complaint for a declaration of ineligibility if Turkmenistan did not provide the data to the Fund by December 13, 2001.

Mr. Collins wondered if such a course of action would be possible from a legal perspective.

Mr. Cippà did not consider that a formal decision would be needed to request the authorities to provide the data without finding them in breach of their obligations at the current stage. He could convey to the authorities a message from the Board strongly urging them to provide the required data within a certain period. There appeared to be considerable support among Directors for the option of allowing the authorities additional time to provide the data. The severity of the situation and the need to deliver the data within the required period could be clearly conveyed in the message, as well as the certainty that the decision to declare Turkmenistan in breach of its obligations to the Fund would eventually be adopted if the authorities again failed to deliver the data.

Mr. Le Gal stressed the need to maintain a balance between giving the authorities the benefit of the doubt and questioning the staff's judgment on the issue at hand.

The Acting Chair (Mr. Aninat), in concluding the meeting, stressed the need for consensus and the need to refrain from creating unnecessary precedents. The staff and management would work on the different alternatives suggested by Directors, and the Board would meet the following week to decide on the proposed alternatives.

APPROVAL: January 22, 2002

SHAILENDRA J. ANJARIA
Secretary