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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/41

10:00 a.m., April 15, 2002

Contents

Executive Board Attendance

H. Köhler, Chairman
A. Krueger, Acting Chair
E. Aninat, Deputy Managing Director
S. Sugisaki, Acting Chair

Executive Directors	Alternate Executive Directors
	A.S. Alosaimi
	A.S. Al Azzaz, Temporary
	N. Guetat, Temporary
	K. Kpetigo, Temporary
I.E. Bennett	C.J. Faircloth, Temporary
	P.R. Fenton, Temporary
M.J. Callaghan	D.C. Guinigundo
R.F. Cippà	W. Szczuka
	T. Skurzewski, Temporary
K. Bischofberger	R. von Kleist
	C. Harzer, Temporary
P.C. Padoan	
D.I. Djojosubroto	Low K.M.
	T. Segara, Temporary
	R.A. Jayatissa
W. Kiekens	J. Prader
	J. Sipko, Temporary
Ó. Ísleifsson	B. Andersen
R. Quarles	M. Lundsager
	J.W. Ralyea III, Temporary
	S. Boitreaud
	S. Boucher, Temporary
	B. Couillault, Temporary
A. Mirakhor	M. Daïri
A.V. Mozhin	L. Palei, Temporary
F. Varela	
T. Scholar	M.A. Brooke
	D. Taylor, Temporary
	R. Junguito
	V. de los Santos, Temporary
	A. Maciá, Temporary
C.D.R. Rustomjee	
	M.B. Chatah
	S.A. Bakhache, Temporary
	Wang X.
	Liu F., Temporary
	Y.G. Yakusha
	A.D. Marinescu, Temporary
	N. Yeritsyan, Temporary
K. Yagi	
	G.R. Le Fort
	R. Maino, Temporary
	C.E. Pereyra, Temporary
	D. Vogel, Temporary

A. Linde, Acting Secretary and A. Mountford, Acting Secretary
Y. Chia, Assistant; T. Davidson, Assistant; J. Puig, Assistant; M. Schulte, Assistant

Also Present

ECB: G. Grisse, B. Kisselevsky. IBRD: T. Baysan, South Asia Regional Office; R. Brigish, Africa Regional Office; L. Frigenti, Europe and Central Asia Regional Office. African Department: A. Bio-Tchané, Director; J. Fajgenbaum, Deputy Director; C. Briançon, G. Kalinga, K. Nassar, M. Nowak, J. Reitmaier, H. Snoek. Asia and Pacific Department: Y. Horiguchi, Director; J. Carter, D. Citrin, D. Kanda, L. Leigh. European I Department: M.C. Deppler, Director; S.M. Schadler, Deputy Director; M. Griffiths, J. Kahkonen, M. Rossi. External Relations Department: T.C. Dawson, Director; W. Camard, Y. Kamata, C. Lotze. Fiscal Affairs Department: A. Annett, M. Cangiano, A. Fedelino, M. Flanagan, G. Tsibouris. International Capital Markets Department: G. Hausler, Director, C.H. Lim, R. Thorne. Legal Department: S.C. Ho, R. Leckow, M. Milford. Monetary and Exchange Affairs Department: S. Ingves, Director; E. Gutierrez, M. Josefsson, D. Marston. Policy Development and Review Department: L. Ebrill, M. Hadjmichael, I. Halikias, M. Hussain, A. McGuirk, S. Singh. Research Department: A. Prati. Secretary's Department: M. Miller, P. Ramlogan. Treasurer's Department: M.G. Kuhn, Deputy Treasurer; C. Hemus, J. Kurtzig. Western Hemisphere Department: A.M. Jul. Office of the Managing Director: S.B. Brown, R. Moghadam, R.S. Teja. Advisors to Executive Directors: I. Abel, M.A. Ahmed, S. Antic, A.S.F. Atoloye, G. Bauche, A. Baukol, M. Beauregard, M.P. Bhatta, B. Bossone, S. Çakir, O.E. Garner, K. Kanagasabapathy, D.H. Kranen, F. Manno, M.F. Melhem, J. Milton, A. Muganda, H.E. Phang, S. Rouai, K. Sakr, J.N. Santos, F. Vermaeten, M. Yanase. Assistants to Executive Directors: M. Abbing, D. Baasankhuu, V. Bhaskar, Cao L., N.J. Davidson, M. Di Maio, P.A. Dohlman, N. Epstein, N.H. Farhan, R. Gauba, E. González-Sánchez, B. Gulbrandsen, F. Haupt, Jin Z., T. Komatsuzaki, I. Kupča, J.K. Kwakye, S. Le Gal, Y. Lissovolik, M. Marques, T. May, D. Merotto, G. Nadali-Ataabadi, M.L. Nikitin, E. Pinto Moreira, Y. Saito, C.A.E. Sdralevich, B. Siegenthaler, A. Stuart, D.B. Waluyo, Wei X., I. Zakharchenkov.

1. TANZANIA—POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT—REVIEW, AND WAIVER OF PERFORMANCE CRITERION

Document: Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion (EBS/02/56, 3/29/02)
Staff: Reitmaier, AFR; Hadjimichael, PDR
Length: 2 hours

Mr. Rustomjee submitted the following statement:

Key points:

Tanzania continues to successfully implement the PRGF-supported program. The excellent performance is a reflection of the commitment and determination of my authorities, including at the highest level, to move the country beyond the economic reform process.

Macroeconomic developments in 2001 were positive and performance under the program remained strong. Preliminary estimates indicate real GDP growth of over 5.1 percent in 2001. Inflation fell to 4.7 percent in January 2002 and international reserves were recorded at above five months of import cover.

All quantitative performance criteria and benchmarks for end-September and end- December 2001 were observed. A structural performance criterion relating to the clearance of audited arrears by end-December 2001 was met later than envisaged due to difficulties in processing related payments in question.

Structural reforms continue to be pursued with vigor, evidenced by the apparent improvement in the business environment, steady prudential financial policies have preserved macroeconomic stability, while emphasis on fiscal transparency has improved public sector accountability.

Implementation of the Poverty Reduction Strategy is on target as reflected in budgetary allocations and other policy interventions.

Introduction

I wish to begin by expressing my authorities appreciation for a well focused and balanced report and express their gratitude to the international community including multilateral institutions and bilateral donors for their continued support throughout this period of reforms. The strong support from the international community truly underlines the concept of partnership in development. To this end, the authorities wish to re-affirm their commitment to economic reforms and to pursuing growth-oriented and poverty-reducing policies.

Recent Economic Developments and Prospects

Tanzania continues to push forward with its ambitious economic reform agenda. Macroeconomic developments and performance under the program remained strong, while structural reforms remained steady despite delays in some areas. Preliminary estimates indicate real GDP growth at above 5.1 percent in 2001, lower than envisaged due to a terms of trade deterioration and a decline in tourism following the September 11 attacks. GDP is projected to grow by 5.5 percent in 2002 depending on adequate rainfall for agricultural output. The 12-month rate of inflation declined to 4.7 percent in January 2002 owing to good performance in agriculture; it is targeted to fall to 4 percent by end-2002. My authorities will remain vigilant to make sure that inflation remains at or near target.

Tanzania's overall performance was commendable. All quantitative performance criteria and benchmarks for end-September and end- December 2001 were observed. A structural performance criterion relating to the clearance of audited arrears by end-December 2001 was met later than expected due to difficulties in processing related payments in question. Staff note the difficulty in establishing conditions for use of land as collateral for bank loans—a benchmark, partially met, under the program (paragraph 5). My authorities have noted staff's concern. To this end, my authorities will review the Land Act of 1999 to determine whether the Act contains impediments that restrict use of land as collateral for bank lending. In this regard, my authorities, with assistance from the World Bank, will contract an independent legal consultant to examine the Land Act and determine, within the existing governing laws of Tanzania, whether there is need for amendment. The process is already underway, the terms of reference have been prepared, discussed and endorsed by the Tanzanian Bankers Association. In the event that the review determines that the Act in its present form inhibits financial intermediation including mortgage-based lending, my authorities will take appropriate measures with the objective of seeking to present the Act for amendment to parliament during the October 2002 session.

Fiscal Policy and Budgetary Reform

On fiscal policy, my authorities remain prudent with respect to maintaining fiscal discipline and committed to enhancing fiscal transparency. The authorities expect to contain the primary deficit for 2001/02 before (grants; excluding interest payments and foreign-financed development expenditure) at 2.9 percent of GDP, in line with the program. Fiscal developments during the first half of the 2001/02 fiscal year were generally in line with the program; staff note the stronger performance of income taxes in comparison with that of value added tax (VAT) collections, which more than compensated for the shortfall in VAT and led to somewhat higher revenue collections than the level targeted in the program. The outlook for the remainder of 2001/02 is also positive, revenue is projected to reach 12.2 percent of GDP in line with the program. Staff note that the recent trend of a relatively stronger performance of income taxes compared to VAT is expected to continue. While strong performance in income taxes is welcome, my authorities share staff's concern regarding weaker performance in VAT.

To this end, my authorities are looking at measures with a view to strengthening VAT administration in the context of the preparation of the budget for 2002/03. To complement their efforts in this area, my authorities have requested technical assistance from FAD, in specified areas of VAT administration, including VAT exemptions. We urge an early and favorable response to this request and underscore the usefulness of Fund technical assistance in Tanzania.

On the expenditure side, a 20 percent expenditure compression was recorded relative to program target, resulting from a shortfall in program financing from the European Union, (EU) due to administrative delays within the EU, and slow adjustment by government agencies to new procurement regulations. Despite the expenditure compression, provision for priority expenditures were ensured through quarterly cash allocations. The provisioning mechanism in place for ensuring funding for priority sectors illustrates the importance which my authorities place on priority expenditures and their commitment to their poverty reduction strategy.

In the context of fiscal decentralization, my authorities are continuing to strengthen fiscal management and transparency at the local authority level. To this end, quarterly revenue and expenditure reports for local governments, on a consolidated and stand alone basis will be published, starting in June 2002 with reports for the first quarter of the year. Publication of these reports is an ongoing exercise building upon various steps that began under the previous review, with a view to increasing harmonization and transparency in the operations of local government. These measures underscore my authorities commitment to fiscal discipline and the determination to further strengthen fiscal management. It is a challenge the authorities wish to address. However, experience in low income countries reveals that there is often weak implementation capacity at the local government level. This is the case in Tanzania, and for this reason we would urge the Fund to continue to provide technical assistance in this area. In addition, we wish to ask bilateral donors to consider providing technical assistance, to assist in this challenging endeavor.

Monetary Policy and Financial Sector

My authorities will continue to aim at maintaining inflation at a low single digit level. The central bank will therefore limit growth of net domestic assets and reserve money to rates consistent with this objective. Recent monetary developments were characterized by rapid money growth, but slower than foreseen growth in credit and falling Treasury bill rates. Broad money grew by 17 percent during 2001, well above program target, while currency in circulation grew by only 5 percent. Bank deposits increased by 22 percent including from newly opened bank branches. The success of mobilizing financial savings and deposits reflects the depth of financial deepening that has taken place in Tanzania, resulting from the ongoing reforms in the financial sector which began a little over than 5 years ago.

Tanzania has achieved considerable success in mobilizing financial savings as a result of its years of financial sector reform. However, in the most recent past, this has been accompanied by lower lending activity, leaving banks with significant excess liquidity. The latter is being successfully mopped by the central bank through open market operations. Part of the excess liquidity is due to the fact that the National Microfinance Bank, one of the largest banks in the country has, until very recently, not been lending. As regards microfinance lending activities in general, since its inception several months ago, this form of lending has been growing rapidly. For example, out of a total 100 non-lending microfinance branches, about 20 branches have begun microfinance lending. It is my authorities expectations that in the course of 2002, another 40 branches will be converted into microfinance lending. Having said that, my authorities are aware of the need to adopt measures that would create an environment that is conducive to lending. In this regard, my authorities will take additional measures with a view to facilitating lending activities. These will include a review of the Land Act of 1999, establishment of a credit information bureau and judicial reforms to ensure enforceability of legal contracts.

FSAP

My authorities have expressed an interest in having a Financial Sector Assessment Program undertaken in Tanzania. They believe that an FSAP will be valuable to Tanzania especially at this time, when all other elements to support continued successful liberalization of the financial sector are in place. In addition, an FSAP would further broaden the ongoing process of financial deepening and could have positive spill over effects beyond the banking sector. We hope that the authorities request for the FSAP will be given early favorable consideration, particularly given Tanzania's excellent track record in the use of Fund and Bank technical assistance.

Beyond HIPC Completion Point

My authorities appreciate the stock of debt reduction granted by Paris Club creditors, but are concerned about the lack of progress in their effort to secure debt relief from non-Paris Club bilateral and commercial creditors on terms comparable to those granted under the HIPC initiative. To make progress on this front, my authorities have decided to establish an external escrow account for these creditors, into which it would pay, starting in fiscal year 2002/03, a significant portion of debt service, estimated to be due to the relevant group of creditors, after full application of the terms of the HIPC debt relief. Once an agreement with a creditor is reached, my authorities will fully honor its resulting debt service obligation, including from the escrow account. In our view, this is a clear example of leadership by a debtor country and my authorities should be commended for taking the lead with a view to defining a resolution mechanism that is acceptable to creditor and debtor. More broadly, we believe that there is a need for the Fund and the World Bank to consider a mechanism that will address this issue in a generic manner. A similar proposal on the same issue was mooted during a recent HIPC forum for commonwealth countries. We believe that it is incumbent on the Fund and the Bank to devise innovative mechanisms to resolve this issue which is of very considerable significance to HIPC members who have struggled for many years to obtain debt relief, only to find that their claims to relief are not being honored.

External Sector

The terms of trade deterioration had an adverse impact on Tanzania's external performance. Performance of exports grew by 16 percent owing mainly to non-traditional exports, in particular gold, while traditional export earnings declined. Imports, driven largely by capital goods and petroleum products, grew by 12.5 percent. Despite the unfavorable external environment, the current account deficit remained stable and international reserves were recorded at above five months of imports of goods and services. As regards the capital account, foreign program assistance from the World Bank, African Development Bank and the European Union was about US$ 100 million lower than programmed amount, due to disbursement delays. The delays were caused in part by nonobservance of a World Bank tranche condition pertaining to the privatization of Dar-es-Salaam Water and Sewerage Authority (DAWASA) which has since been met. The bid documents for DAWASA have been received and opened; and the evaluation process to determine the winner is now underway. The other reason for the disbursement delays was due to administrative delays on the part of the European Union.

Other Structural Reforms

My authorities continue to pursue privatization of public enterprises with a focus on public utilities and large financial enterprises. During 2002, my authorities intent to put into private hands at least the management of Dar-es-Salaam Water & Sewerage Authority (DAWASA), the Tanzania Railways Corporation (TRC), the Tanzania Harbors Authority (THA), the Air Tanzania Corporation (ATC) and the Tanzania Electric Supply Company (TANESCO). However, my authorities wish to convey their concerns about the treatment of parastatal debt and the costs of retrenchment. The authorities policy on parastatal debt has been considered in their domestic debt strategy, with both direct and contingent liabilities taken into account. The policy for parastatal retrenchment is to offer statutory payments only.

With regard to TANESCO, on March 30, 2002 cabinet approved a contract with a foreign private firm management, to manage TANESCO effective May 1, 2002. In addition, my authorities approved a new schedule of tariffs, effective April 1, 2002. With regard to DAWASA, my authorities received and opened bids and tender documents for a 10-year lease on March 27, 2002. The evaluation and selection process is now underway to determine a winning bidder. As regards TRC, a law has recently been passed by parliament to allow divestiture of TRC. The next stage is to invite tenders for bidding. Regarding THA, the consultancy study has been completed and is awaiting submission to cabinet. The process of privatizing ATC is also underway. To expedite the process, my authorities have de-specified the company and transferred the responsibility of privatization from the Privatization Agency, which in this instance is seen to have cumbersome procedures, to the Ministry of Transport and Communication.

Poverty Reduction Strategy

The implementation of the poverty reduction strategy formulated in the PRSP has high priority. My authorities will ensure that debt relief under HIPC Initiative continues to be directed to towards priority areas identified in the PRSP. In order to allow for better tracking of outlays in priority sectors, my authorities will report these expenditures in a consistent format across the PRSP, the budget and the quarterly execution report. Moreover, an important focus will be on implementing the new education and agricultural sector strategies indicated in the PRSP progress report, and in finalizing the poverty analysis based on the results of the 2000/01 household survey. The household survey has been evaluated and up-to-date poverty indicators are being developed. Conclusions from the analysis will be discussed during the next PRSP progress report.

To complement the PRSP process, my authorities are putting emphasis on identifying sources of growth that would be poverty-reducing, given rapidly rising expenditures in the social sectors and the aim of progressively reducing Tanzania's dependency on external assistance. In the same vein, the authorities realize the need to focus their efforts increasingly on domestic resource mobilization to finance public services needed to achieve its development goals.

Conclusion

The benefits of the reform process have begun to become apparent as evidenced by developments in the financial sector, in particular, mobilization of financial savings and deposits. My authorities have demonstrated a resolve to the reform process, and are now beginning to look at "beyond or after" the first round of the reform process. They have demonstrated a track record which is self-evident and their commitment to meeting the challenges is being demonstrated through various initiatives of their own. However, technical assistance as well as concessional assistance remains critical in complementing the limited and over-stretched human resource and financial resource capacity of the authorities. Moreover, the main issue that the authorities are now grappling with is the sources of growth issue and how to unleash entrepreneurial spirit within Tanzania. My authorities welcome a dialogue on this front. They have started the process by scheduling meetings to allow exchange of views between the President and selected high-ranking officials and the private sector. My authorities request the Board to grant waiver for nonobservance of the performance criterion relating to the clearance of domestic arrears.

Extending his remarks, Mr. Rustomjee considered that Box 1 of EBS/02/56 on structural conditionality was very useful, particularly in explaining why other relevant structural actions were not included in the current program. His chair had been asking for such explanations about structural measures before, and welcomed the inclusion of that box.

With regard to Paragraph 31 of the staff appraisal on page 11 of the staff report, Mr. Rustomjee welcomed the reference to the authorities' formulation of a public debt strategy, including particularly stock-taking of contingent domestic liabilities and tightening of approval procedures for foreign borrowing. However, the second sentence of that paragraph was somewhat problematic when it said that the latter action was useful to ensure that the burden of external debt remained sustainable. It would be difficult, under any circumstances, and in any country, to ensure that external debt remained sustainable. One example for that was Tanzania's neighbor, Uganda. Despite all of the measures that the Ugandan authorities had taken with regard to approval procedures for foreign borrowing, stock taking of contingent liabilities, and so on, the sustainability of external debt could not be ensured. A better wording might have been "to try to ensure" so as to avoid any misunderstanding.

Mr. Rustomjee thanked Directors who had issued statements and noted that Tanzania was an example of a country that was starting to come out of the first generation cycle of reforms and was beginning to make headway in dealing with all those other challenges that a successful performer in the African context would have to deal with: accessing international capital markets in a more meaningful way and trying seriously and systematically to exit from concessional assistance—a major challenge for any African low-income country. However, it was the first example of a country that had done everything that had been asked of it by the Bretton Woods institutions and by its own domestic authorities, and was trying to break out of what had in the past been a seemingly perpetual cycle.

Mr. Mirakhor submitted the following statement:

Key points

Tanzania continues to reinforce its adjustment and reform policies, with impressive results. We support the completion of the fourth review of the PRGF and waiver of the performance criterion on clearance of domestic arrears.

Concurrent with maintaining macroeconomic stability and the pace of poverty reduction, policies in 2002 should focus on reinforcing revenue mobilization, promoting financial intermediation, and accelerating key structural reforms.

Fiscal policy needs to be bolstered by a strong revenue effort to provide a firm anchor for the government's program.

The government's poverty reduction strategy is on course and the maximum support of all creditors is important to sustain the momentum.

We thank staff for a well-written paper and concur with the thrust of their appraisal. We also thank Mr. Rustomjee for his clear and informative statement.

Tanzania continues to reinforce its adjustment and reform policies with impressive results. Against the backdrop of the global economic slowdown—which affected its commodity export prices and tourism industry—and the slow disbursement of aid, Tanzania posted strong growth in 2001, concurrently with macroeconomic stability, mainly due to its prudent policies. Fiscal performance was kept on track, with better revenue performance and a sharp reduction in overall expenditure, while social outlay was protected. Monetary policy continues to be prudent and, notwithstanding the higher-than-projected money growth, the inflation target was not undermined. External sector performance was also satisfactory, as exports grew more rapidly than imports, allowing a significant build up in reserves to a comfortable level. The authorities have made commendable progress in structural reforms and governance. On the basis of their achievements and resolve, we support the completion of the fourth review of the PRGF and waiver of the performance criterion on clearance of domestic arrears. Concurrent with maintaining macroeconomic stability and the pace of the poverty reduction program, policies in 2002 should focus on reinforcing revenue mobilization, strengthening and enhancing financial intermediation, and accelerating key structural reforms.

Fiscal policy needs to be bolstered by a strong revenue effort to provide a firm anchor for the government's program of adjustment, reform, and poverty alleviation. It is encouraging to note that the government recognizes the strong need to focus on domestic resource mobilization in order to reduce Tanzania's dependence on external assistance. Indeed, to position itself to be able to mitigate potential disruptive effects of large shortfalls in external resources—such as occurred in 2001, which necessitated a cutback of 20 percent in expenditure—the government should forcefully implement its revenue mobilization plan, detailed in paragraph 13 of the MFEP. In this context, we continue to be highly concerned about the negative impact of shortfalls in external resources on economic performance of many countries to the point that this is becoming a systemic issue.

We particularly welcome plans to assess the functioning of the large tax payer unit, and plug loopholes in the tax-exempt scheme for development projects by bringing them to a tax-inclusive basis. Plans to reverse the declining trend of VAT with Fund TA, including by strengthening its administration and extending it to cover financial services, are also in the right direction. Removing government exemption from customs duties and excise taxes should help to reduce abuse and revenue loss to the Treasury.

On the expenditure side, the government has adopted a prudent policy of maintaining a tight grip on spending, restricting domestic borrowing, and clearing remaining arrears while protecting priority sector spending under the poverty reduction program. However, significant contingent expenditure is bound to arise from the restructuring of parastatals, calling for vigilance and a readiness by the authorities to make any adjustments that may be required to protect the integrity of the program.

Monetary policy in 2002 is being appropriately tightened—by restoring positive real interest rates, limiting bank financing of the budget, and intensifying liquidity operations—geared to containing inflation and building reserves. More significantly, credit expansion to the private sector is being expanded in line with expected growth in economic activity. We welcome the authorities' intention to address the impediments to financial intermediation elaborated in Box 2 by reducing the high risks and operating costs in the financial sector. Particular attention should be paid to strengthening collateral laws, contract enforcement, and streamlining the tax on loan provisions. The authorities' request for FSSA is an important step toward strengthening the financial sector and "broadening the ongoing process of financial deepening."

Developing micro-finance institutions also deserves priority consideration as a vehicle for ensuring easy access to credit by small-scale and rural enterprises. On the positive side, savings mobilization has been quite successful, reflecting the "depth of financial deepening" in the economy.

The authorities have demonstrated a strong commitment to structural reforms, including particularly a bold privatization program involving key public enterprises. The implementation of cost-saving measures for TANESCO in tandem with adjustment of electricity tariffs should help reduce the burden on consumers. By adopting the core conventions of the ILO to be incorporated in a new labor law, the authorities have taken an important step toward their goal of ensuring "a clear and balanced labor legislation". The government appears resolute about promoting good governance, particularly in fiscal transparency and accountability, and in combating corruption. The efforts to enhance public expenditure management, including through better recording and reporting of priority outlays and donor-funded project expenditure, are noteworthy. We welcome the introduction of a commitment control system, which prevents MDAs from incurring arrears, and are pleased to note the authorities' determination to strictly enforce it. The new participatory approach to public expenditure reviews should serve as a vehicle for mobilizing consensus on prioritization of public projects. Fiscal management and transparency are being appropriately strengthened at the local government level, while a strict cabinet oversight over all new government borrowing is being institutionalized. The determination of the stock of public domestic debt, including contingent liabilities related to parastatal debt, and the planned timetable for restructuring eligible parastatals, are important steps toward ensuring a clean slate for the parastatals prior to their privatization as well as easing the strain on the budget.

Structural conditionality has been appropriately streamlined under the program, focusing on the Fund's core areas of responsibility. It has been difficult to establish conditions for the use of land as collateral for bank loans, and Mr. Rustomjee has given a clear indication of the authorities' resolve to move forward on the issue. In the same vein, it is appropriate to sequence the conditionality on import surcharges in line with the government's plan to announce a timetable for their elimination, while developing anti-dumping legislation in line with WTO rules. It is noted that the World Bank is also covering other key areas of conditionality under its competence.

The government's poverty reduction strategy is on course and promises to yield encouraging results. Particularly noteworthy is government's determination to achieve the targets and outcomes in the PRSP by ensuring that budgetary allocations and other policy interventions reflect the earmarked priorities. We look forward to the next PRSP progress report. While multilateral and Paris Club creditors' contribution to debt relief at the completion point of the HIPC Initiative has been promptly delivered, non-

Paris Club bilateral and commercial creditors' contribution remains outstanding. The establishment of an external escrow account by the government to service any remaining debt to creditors after application of the terms of HIPC Initiative debt relief should encourage the remaining creditors to deliver their commitments. We support Mr. Rustomjee's call for a formal mechanism for dealing with this problem, which could afflict other HIPCs.

Mr. Kelkar submitted the following statement:

We thank the staff for a well-written report and Mr. Rustomjee for his helpful statement. We commend the Tanzanian authorities for their creditable performance under the PRGF-supported program. The only structural performance criterion that was missed has also subsequently been met and the delay well explained. We, therefore, support the proposed decisions.

A robust GDP growth despite the global downturn and the weakening of commodity prices, particularly coffee; and decline in the rates of inflation testify to a determined macroeconomic performance by the authorities. We agree with the staff on the need to address the issues inhibiting the growth of bank lending commensurate with the increase in deposits. Reform of land ownership laws is overdue and would provide impetus to fresh investment. There could be genuine difficulties in forging the necessary consensus on an issue with wide social and economic implications. We would like to impress on the authorities, however, that the longer such a change is delayed, the higher might be the costs to the economy. We welcome their initiative for appointing a consultant to study the entire gamut of issues related to this and hope that this would be followed up by legislative measures as considered necessary. We are happy to learn from Mr. Rustomjee's statement that the authorities are taking other equally important measures like expansion of micro credit and reform of contract laws to spur growth of credit and investment. In the meantime, they have taken requisite measures to mop up excess liquidity. The proposed regional integration and trade liberalization should also provide further stimulus to economic growth. We are pleased to note the continuing progress on the agenda of privatization.

On the fiscal side, we appreciate that the slippages in expenditure were due in part to new procurement regulations put in place but expect that the process of adaptation would soon be completed. The staff has reassured that the priority sector expenditure wasn't affected and this has been confirmed by Mr. Rustomjee in his statement. The shortfall in the expected foreign program assistance, underscores once again the deleterious impact of the unpredictability of donor flows. We encourage the authorities to tighten tax exemptions. We are concerned, however, about the impact of the projected rise in the civil service wage bill. The decompression of salaries to make them attractive enough to retain high caliber individuals is a perfectly valid concern. Especially if the delivery of public services is to improve qualitatively so that the gains from the PRSP process and increased poverty reducing expenditure can be fully reaped. However, we would urge the authorities to simultaneously look into the issue of superfluous and excessive employment, something not uncommon in the public sector, so that, overall, there is minimal impact on the government's budget.

The staff report refers to the request made by them to the authorities to include all public investment projects in the "newly strengthened and participatory approach" to public expenditure reviews. This is in the context of a controversy over purchase of a new air traffic control system. The staff's concern for optimal utilization of public resources and to check wastages and slippages is well taken. However, we are not sure whether subjecting every public investment project to a participatory process is the appropriate solution. This is the function of legislative, judicial and constitutionally ordained audit institutions. There could be a case for strengthening these. However, opening up executive decisions to a loosely defined and amorphous participatory process may create more problems than it would solve.

We welcome the measures being taken by the authorities to improve debt management. Tanzania is one of the first countries to have reached the HIPC completion point and it is important that the sustainable external debt situation is preserved. The Tanzanian authorities have demonstrated their capacity for a sustained impressive economic performance and we wish them continued success in their endeavors.

Mr. Guetat made the following statement:

At the outset, we thank the staff for the candid assessment of the economic situation in Tanzania, and Mr. Rustomjee for his helpful and very informative statement. Tanzania's macroeconomic performance under the PRGF program is commendable, with real GDP estimated at 5.1 percent in 2001, a declining inflation rate, and a comfortable level of international reserves. It is also noteworthy that, under the program, some major progress has been achieved. All quantitative performance criteria and benchmarks were observed. Despite the delay in the clearance of audited domestic arrears, the structural PC has also been observed. Since we broadly concur with the thrust of the staff appraisal and support the proposed decisions, including the waiver for the nonobservance of the PC, we will concentrate our remarks on two main issues: fiscal policy, and structural and financial sector reforms.

Turning to fiscal policy, regarding the revenue performance, we are pleased to note that the program targets were largely exceeded. However, given the country's strong need to rely more on domestic revenue, we urge the authorities to continue their effort to boost revenue collection. To this end, we concur with the staff that improving tax administration and reducing tax exemptions will be key. The budgetary prospects for the rest of 2001/02 seem reassuring. However, given the extra efforts required for revenue mobilization, we would like to know the financial impact of the elimination of the import surcharges in the 2002/03 budget, in particularly how the revenue from these surcharges will be compensated. Clarification on this would be welcome.

On the expenditure side, we are pleased to note that the compression of expenditure did not affect priority sector programs. It is also noteworthy that in the 2002/03 budget, in line with the PRSP, priority sector spending will rise to about 9.6 percent of GDP. On the domestic debt strategy as laid out in Box 3, the size of the debt, while remaining manageable, is a source of concern, since clearing the arrears in the forthcoming budget could hamper the government's efforts to invest in priority social sectors. While we are pleased to note that the government is taking this issue seriously, we agree with the staff that sound debt management will be a centerpiece of the program. In this regard, we welcome the authorities' decision to submit any new foreign loan to cabinet approval.

The government's decision to focus additional efforts on the tracking of outlays in priority areas is encouraging. Fund technical assistance will be needed for the reform of the public expenditure management system. We welcome Mr. Rustomjee's reassurance that the authorities are continuing their efforts to strengthen fiscal management and transparency at the local authority level. In light of the challenge facing the authorities on that issue, we would like to support Mr. Rustomjee's call for bilateral donors to provide adequate technical assistance in this area.

Turning to structural reforms, as regards the privatization program, given the recent difficulties experienced in some countries with the privatization of the electricity sector, we call for a cautious approach in Tanzania. More major foreign electricity companies that could invest are facing serious difficulties. Meanwhile, the authorities need to take decisive actions to stabilize the financial situation of the state-owned enterprises mainly TANESCO and DAWASA, without any further budgetary transfers. Here, we are reassured by Mr. Rustomjee on some steps already taken by the authorities. We also note that a tariff adjustment might be required to reduce the deficit of some of these companies. In this case, we call the attention of the authorities to providing some safety net for the poor segments of the population.

Turning to financial sector reform, the staff seemed to make the amendment of the Land Act the key condition for successful reform. While we agree that the reform will certainly help, we need to keep in mind that a consensus has not yet emerged. This is an area where the government cannot impose its decision on members of parliament, who will need to build a consensus for a market-based approach to land ownership. It will take time, and meanwhile there is a need to press ahead with the other reforms and to reduce the various impediments to bank lending. Government actions to remove impediments to bank lending, as presented in Box 2, are a move in the right direction. The strengthening of the commercial court could help. Moreover, the Tanzanian Bankers Association's intention to establish a credit information bureau is also a necessary first step to improve bank lending. Banks should also concentrate more on the training of personnel in business-related fields and even recruit more financial and corporate analysts. Given that poverty is widespread in rural areas, the authorities should focus more on developing microfinance institutions as a means of creating activities in rural areas; this is a point also stressed by Mr. Mirakhor in his statement.

With regard to the financial sector, we welcome the authorities' intention to participate in the Financial Sector Assessment Program. With these remarks, we wish the Tanzanian authorities every success in their endeavors.

Mrs. Marinescu made the following statement:

I would like to commend the Tanzanian authorities for prudent policies and progress in implementing the PRGF. The consistent policy mix over the last years and almost full observance of program targets are the basis for our support of the completion of the fourth review under the PRGF. We welcome the authorities' efforts to maintain macroeconomic stability and to implement structural reforms directed to generate growth and to alleviate poverty.

It is encouraging to see Tanzania's further commitment to addressing the major challenges ahead, such as improving the structure of the economy to ensure better protection against weather and external shocks; strengthening financial management in order to promote budget transparency, control, and accountability; continuing the process toward privatization with a focus on public utilities; and improving governance.

I would like to make a few comments on specific areas. Structural reforms are crucial for the success of the program and the efforts to accelerate economic growth, improve productivity and competitiveness, and over the medium term reduce poverty. Public debt management, by adopting a domestic debt strategy and making new foreign borrowing subject to cabinet approval, is an important structural measure and represents the recognition of its role for improving the business climate. Clearance of the audited domestic arrears in March 2002 has been an important signal for reaching this goal. It would be interesting to know if these arrears were paid by the donors or by the central and local governments. At the same time, according to our information, there are domestic arrears that were not approved by the auditors. I would appreciate the staff's comments on the size of these arrears and their status.

The continuation of structural reforms will have an impact on labor market development and on social benefits in the budget. In the Memorandum of Economic and Financial Policies, the authorities are expressing their commitment for the level of one month's statutory payment only, as the policy on retrenchment in parastatals. Box 3 mentions a recent case in which 12 months' salary was offered in a public enterprise, and there have been demands for even higher payments. The rigidities of the labor market will create more pressures in that direction, and this issue should therefore be carefully monitored. At the same time, I do not know what are other labor possibilities or incentives in place for starting a small- or medium-sized private business with this higher amount of money.

Regarding the foreign debt situation, as a result of the support under the HIPC Initiative, a remarkable improvement is expected until the year 2020, which should bring Tanzania in the league of countries with a normal debt situation. It is interesting to know what the IMF is advising Tanzania to be a sound debt strategy in the coming years. Should the government, among others, aim at substituting loans by grants, if that is possible? In this respect, we could mention the Netherlands' offer of US$50 million for the education sector.

I wish the authorities success in their challenging tasks.

Mr. Brooke made the following statement:

I agree with staff that the Tanzanian authorities have continued to make good progress with macroeconomic stabilization under their PRGF program. I, therefore, support the proposed decision and the waiver of the performance criteria relating to domestic arrears.

It is particularly encouraging to see that, despite the deterioration in global economic conditions, Tanzania achieved real GDP growth in excess of 5 percent last year, along with continued moderate inflation and fiscal stability. This performance suggests an increasing robustness of the economy; no doubt related to the benefits of the ongoing reform programme.

The approval of Tanzania's HIPC completion point in November of last year marked a major mile stone for the country. It triggered immediate debt relief from the IFIs and Paris Club bilateral creditors. In the short-term, we support the efforts being made by the authorities and staff to ensure that all other creditors also provide debt relief on comparable terms. In this regard, it would have been helpful to have included more detail in the staff report about who these creditors are.

More generally, the approval of Tanzania's Completion Point should be used as a trigger to re-examine the authorities' longer-term development strategy. Improvements in debt management and contingency planning need to be put in place to avoid any recurrence of debt servicing problems. These efforts need to go hand-in-hand with enhancements to public expenditure management and governance, better prioritization of government investments, and a comprehensive long-term strategy to increase growth and reduce poverty.

The authorities' focus on preserving macroeconomic stability and promoting growth and employment in the private sector will play a crucial role in the efforts to reduce poverty. And, there appear to be some signs that this approach is already delivering improvements. For example, per capita GDP has been increasing in recent years. Other indicators, however, appear to suggest that this rise in incomes has not been evenly distributed across the population.

The poverty indicators being developed from the latest household budget survey will, therefore, provide an important additional source of information. Going forward, these indicators should be used to assess the effectiveness of individual policy measures. We therefore look forward to learning about the conclusions from this analysis in the next PRSP progress report and hope that it will facilitate a broader discussion of the inter-linkages between growth and poverty.

I would now like to make a number of comments on the programme priorities.

Fiscal policy

As highlighted in the staff appraisal, one of the authorities' long-term goals should be to rely increasingly on domestic revenue to finance its development goals, rather than relying on external assistance. This implies that the authorities need to formulate a coherent strategy to gradually increase government revenues, based on improvements in tax administration, the elimination of tax exemptions, and the gradual increase in both income tax and VAT rates. Harmonization of local authority taxation policies will also be important in this regard.

On expenditures, we support the authorities' intention to pursue further reforms to enhance public expenditure management and we commend the measures they are taking to improve the transparency of public spending. The reforms at the central government level are already beginning to bear fruit. But, there is still a long way to go at the local level. Compliance with the June 2002 benchmark on publishing local government accounts will be an important signal in this regard.

The prioritization of the government's investment choices has been brought into focus recently by the authorities' decision to purchase a new air traffic control system. We strongly endorse staff's suggestion for the authorities to make all large-scale government investment projects subject to a transparent public expenditure review process that would critically consider both prioritization and value-for-money considerations before finalizing spending commitments. We therefore welcome the new programme performance measures in this area.

We support the intention to increase the share of spending allocated to poverty alleviation sectors and agree with the authorities' intention to report all such spending on a consistent basis across the PRGF, the PRSP and the budget. In the reporting on this priority spending, I wonder whether it would be helpful for the authorities to further disaggregate the sub-sector totals. For example, not all health spending is a priority for poverty reduction. Such an approach obviously involves subjectivity and so I would be interested to hear from staff whether or not they feel it would be either meaningful or practical.

My authorities accept the case for a rise in the wages of Tanzanian civil servants to help retain good quality staff. At the same time, however, we feel consideration should also be given to the scope for public sector retrenchment and the authorities should ensure that any increase in the total wage bill is capped and monitored closely.

As we highlighted in last week's Board discussion, we support all of staff's recommendations in the areas of improving the debt management practices in HIPC countries. We hope that the authorities are now in a position to routinely and comprehensively make medium-term projections of their debt sustainability position. It would be useful if the next staff report were to include such information.

Given that domestic debt is only around 16 percent of GDP, there are clearly fewer concerns about domestic debt sustainability than for external debt. That being said, I was concerned to read in box 3 that a recent retrenchment by a public enterprise involved the payment of 12 months' worth of salaries and benefits to the staff that were laid off. The authorities will need to be firmer about sticking to the statutory minimum levels of retrenchment pay if the cost of reforming the state owned enterprises is to be kept within reasonable limits.

Monetary policy

I found it difficult to reach a firm judgment about the discussion in the staff report relating to the linkages between broad money, liquidity conditions, credit growth and inflation. Staff note that the stock of M3 increased by 17 percent in the year to December 2001, due to strong growth in deposits, and that these gains were not matched by greater lending activity. Looking at the disaggregated data, suggests that the most significant developments for bank balance sheets were that credit to the government declined sharply while foreign currency deposits increased strongly.

In these circumstances, I agree with staff and the authorities that it is appropriate for the BoT to mop up the excess liquidity that has been created by the government's reduced demand for bank credit. Neutralizing the impact on the money supply of changes in the government's position with the banking sector is a normal part of any central bank's open market operations. The difficulties faced by the BoT in undertaking this task and the central bank's decision to convert part of their holdings of nonmarketable government debt into marketable securities points to an inadequate supply of tradable government debt securities for sale and repurchase arrangements. I would be interested to hear from staff about their recommendations to the authorities in this regard.

Banking sector

Turning to financial intermediation, we agree with all of the steps outlined in box 2 to reduce the impediments to bank lending. Greater efforts to promote microfinance institutions will also be essential if banking intermediation services are to be extended to rural communities.

I understand that one of the key reasons for bank lending in Tanzania has been distress borrowing from private contractors to finance domestic arrears. No doubt, the government's actions to eliminate its arrears will have helped to alleviate this issue. I'd be grateful to hear from staff whether they think the authorities' actions in this area will help to reduce bank spreads between loan and deposit rates?

I support the authorities' application for an FSAP. I hope that this work will build on the World Bank's previous analysis in this area, thereby avoiding unnecessary duplication of effort.

Finally, we welcome and support the authorities' ambitious privatization agenda. It will be important that these efforts are proceeded by, or are undertaken in parallel with, the establishment of appropriate pro-competitive regulatory frameworks that ensure minimum standards of service delivery without compromising basic health and safety standards. I notice that such regulatory reforms are meant to be one of the tranches in the Bank's structural adjustment credit. Please can staff tell us whether they are coordinating the timetable of the PRGF privatization benchmarks with the Bank's regulatory work. It will also be important, as part of the pre-privatization preparations process, for all the state owned enterprises to reduce their reliance on budgetary support from the government.

I wish the authorities every success with their reform agenda.

Mr. Ralyea made the following statement:

Policy implementation under the program remains very strong. We look forward to further successes and only would like to highlight a few areas where the authorities perhaps could accelerate reform efforts for the betterment of all Tanzanians. Some of these reforms are helpfully included as structural measures under the program.

First, we welcome the authorities' focus on strengthening revenue mobilization. With tax revenue still only equivalent to 11 percent of GDP, much more can and should be done. As the staff points out, Tanzania will need to rely increasingly on domestic revenue, rather than external assistance, to finance the public services needed to achieve its development goals. While we recognize that this has been a priority policy objective for some time, we would still strongly support the staff's recommendation that the authorities pay particular attention to improving tax administration and reducing tax exemptions. We also urge the authorities to remove last year's import surcharges as soon as possible.

Second, the staff identified a number of impediments to bank lending. We urge the authorities to remove these impediments as soon as practicable. In particular, the government should aggressively follow through on its promises to improve the land registry and to propose any legislative changes that may be needed to the Land Act by October 2002. We also encourage the authorities and the staff to re-insert a meaningful structural performance measure on facilitating the use of land as loan collateral into the program for the sixth review. Further, would the staff elaborate on the business community's concerns about the creation of a Land Division in the High Court?

Given the above, we suspect that managing excess liquidity in the banking system will continue to challenge the monetary authorities. Thus, we welcome the more conservative estimates for growth of credit to the non-government sector and the concomitant downward revision in reserve money growth.

Third, Tanzania's ranking in the 2001 Transparency International survey of corruption perceptions bespeaks the need for the government to keep moving forward aggressively with efforts to stem corruption and improve governance. We look forward to the establishment of the commission for human rights and good governance later this year and the publication of quarterly revenue and expenditure reports for local governments in June. We also appreciate the planned publication of the second report on the implementation of ministerial anti-corruption plans in

September. Along these lines, we urge the authorities to consent to publication of this report.

Finally, would the staff please comment on the authorities' response to the staff's recommendations that came out of the safeguards assessment?

Mr. Sipko made the following statement:

Tanzania's authorities are to be commended for successfully implementing the PRGF-supported program. Macroeconomic developments and Tanzania's track record remain positive. All quantitative performance criteria and benchmarks for the end of September and the end of December 2001 were met. Only one structural performance criterion, related to the clearance of audited arrears by the end of December 2001, was missed due to difficulties in the processing of payments. Structural reforms have been in line with the program. But despite these positive results, the authorities face some challenges, especially in the areas of improving revenue collection and fiscal transparency, strengthening the financial sector, continuing privatization, and improving governance and debt management.

Let me now turn to some of these issues. Increasing Tanzania's spending for social goals and decreasing its dependence on foreign assistance will require strengthening tax administration and fiscal policy. Even though the revenue performance in the first half of the financial year 2001-2002 is in line with the program, it will be critical to improve the collection of the VAT. Since the latter need seems to be related to administrative capacity, we support the authorities' request for technical assistance from FAD in matters connected with the VAT, especially including VAT exemptions. We know from the staff report that the authorities intend to eliminate the import surcharge. Could the staff tell us what effect this will have on revenues?

In the area of fiscal decentralization, there is a need to improve fiscal management and transparency at the local level. Quarterly revenue and expenditure reports from local authorities would be a good starting point. In addition, we encourage the authorities to strengthen fiscal discipline and fiscal management, and therefore support Mr. Rustomjee's request for continued technical assistance in this area.

Although monetary policy is still keeping inflation at single digit levels, the Bank of Tanzania (BoT) should limit the growth of net domestic assets and reserve money to rates consistent with that goal. As for the excess liquidity in the financial system and promoting financial deepening, we encourage the BoT to convert part of its holdings of nonmarketable government debt into marketable securities that can be sold to financial institutions.

The authorities are committed to overcoming difficulties in the financial sector, especially those related to high risk and high operating costs. The inability of Tanzanians to pledge land as collateral for bank loans is critical. We were glad to learn from Mr. Rustomjee's statement that the authorities are reviewing the Land Act of 1999 to determine if it contains impediments restricting the use of land as collateral for bank lending. In addition, we support the authorities' request for a Financial Sector Assessment Program.

Even though Tanzania's domestic public debt is still manageable, the external debt situation needs to be improved, especially by securing debt relief from non-Paris Club bilateral and commercial creditors on terms comparable to those granted under the HIPC initiative. In this connection we welcome the authorities' decision to establish an external escrow account for these creditors, into which they would make payments beginning in fiscal year 2002-2003.

Based on Tanzania’s macroeconomic performance, program implementation, and strong track record, we can support the proposed decision and wish the authorities all success in their long effort to reduce poverty.

Mr. Liu Fushou made the following statement:

At the outset, we would like to thank staff for their well-written paper and Mr. Rustomjee for his informative and helpful statement. The Tanzanian authorities should be commended for their creditable performance under the PRGF-supported program. Macroeconomic developments in 2001 were remarkable. Real GDP growth is estimated at 5.1 percent, inflation fell to 4.7 percent in January 2002, and international reserves remained well above five months of imports of goods and services. In addition, all quantitative performance criteria and benchmarks for end-September and end-December 2001 were observed. The only structural performance criterion that was missed has also been met and the delay well explained. We, therefore, fully support the completion of the fourth review of the PRGF and waiver of the performance criterion on clearance of domestic arrears. We concur with the thrust of the staff appraisal and will limit our remarks to a few areas for emphasis.

On the fiscal front, we commend the authorities for their efforts to maintain fiscal discipline and enhance fiscal transparency. It is encouraging to note that the authorities recognize the strong need to focus on domestic revenue mobilization to reduce Tanzania’s dependence on external assistance and we welcome the implementation of their revenue mobilization plan, detailed in paragraph 13 of the MFEP. We also welcome plans to assess the functioning of the large taxpayer unit and measures to strengthen VAT administration with Fund TA. On the expenditure side, we commend the authorities for their strong commitment to fiscal discipline, while to protecting priority sector spending under the poverty reduction program. On fiscal decentralization, we welcome progress made in strengthening fiscal management and transparency at the local level, and encourage the Fund to continue to provide technical assistance to improve implementation capacity at the local government level.

On the monetary policy, we are pleased to note that monetary policy will continue to aim at keeping inflation at low single digits and that the monetary program will allow credit to the private sector to increase in line with the expected growth in economic activity and further financial deepening. We welcome the authorities' intention to address the impediments to financial intermediation elaborated in Box 2 and underscore the importance of strengthening collateral laws, contract enforcement, and streamlining the tax on loan provisions.

On structural reforms, we welcome the progress that continues to be made in the government's privatization program, with focus on public utilities and large financial enterprises and encourage the authorities to maintain this momentum to create the environment conducive to sustainable economic growth. We are of the same view that structural conditionality should continue to focus on the Fund's core areas of responsibility under the program.

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

Mr. de los Santos made the following statement:

Tanzania's suitable implementation of the PRGF arrangement and the country's satisfactory economic performance during 2001 shows how a right mix of authorities' commitments and appropriately designed Fund-supported programs can produce encouraging economic advancements. All end-September and end-December quantitative performance criteria and benchmarks were met, some of them with favorable margins. Alongside, real GDP growth was strong, inflation was subdued, and foreign reserves were raised to a comfortable level.

Good budgetary management allowed for a stable fiscal stance. An important factor on this result was a better than programmed revenue performance. We congratulate the authorities for this achievement, and understand that there is still margin for further improvement. Tax revenues in terms of GDP remain low and about the same level for the most recent years. Tanzania's tax system is still fragile so actions should be developed to enhance tax administration and eliminate the distortions created by VAT exemptions. In this connection, we commend the authorities' intention, noted in Mr. Rustomjee's substantive statement, to strengthen VAT Administration in the context of the preparation of the budget for 2002-3. Also, we support the authorities' request to the Fund for a TA on VAT administration, and look forward to see the mission sent to Dar es Salaam promptly.

We share the staff's view that the authorities should significantly improve their capacity to generate domestic revenues to finance the increasing needs for economic and social development. This is actually more pressing due to the projected decline in tax revenue given the reduction in the top tariff rate and in some import surcharges, stemming from the welcome intention to deepen trade liberalization in Tanzania.

Although inflation has been on target, 2001 was a year when broad money increased considerably. A tight stance is in order to restrain potential inflationary pressures arising from a significant excess liquidity in the financial system. At the present junction, the most pressing need is to strengthen the financial sector by correcting the growing imbalances that come up from demand for deposits growing faster than lending. In this regard, we agree with the staff's view that the authorities should concentrate their efforts to help remove constraints to bank lending, especially by modifying the Land Act of 1999 to allow the use of land as loans collateral. We recognize the authorities' intention to continue improving the financial system health and, in that connection, we welcome their decision to request an FSAP.

Progress in the implementation of structural reforms has been encouraging, particularly in the privatization of public enterprises and the adoption of new labor regulations in line with international standards. As previously indicated, we look forward to a punctual revision of the Land Law to create the appropriate legal framework for the operation of an open and efficient land market in Tanzania.

Though logistics constraints to process payments prevented the timely observance of the end-December performance criterion on audited domestic arrears, we see as very positive that later an even greater amount of arrears was cleared. This speaks well of the authorities' commitment and, consequently, draws our support to approve their request for a waiver of such a performance criterion.

With these comments, we support the proposed decision and wish the authorities well in their economic and social endeavors.

The staff representative from the African Department (Mr. Reitmaier), responding to Mr. Guetat's question on the budgetary impact of the reduction in import surcharges and on compensation for any potential revenue loss, noted that the staff and the authorities did not expect any sizable impact on revenue. In fact, revenue from import surcharges was minimal and had not been separately identified. The surcharges had been used as a protective device. Given that they were so high as to make imports of the concerned items practically prohibitively expensive, the revenue implications of their removal would not constitute a problem.

On the issue of the use of land as collateral, the staff representative noted that Mr. Guetat seemed to have been under the incorrect impression that an amendment of the Land Act was a matter of program conditionality and had suggested that this was not appropriate. On the other hand, Mr. Ralyea had recognized that there was no such condition, but had suggested that there should be conditionality on that issue. Those positions mirrored to some degree the discussions that the staff had had with the authorities. In the end, the condition of amending the Land Act had been dropped. The staff had stressed that this matter could not be taken lightly and that the reform of the Land Act would be a critical improvement in the ability of the banking system to lend against land as collateral. While the authorities agreed with that in principle, their approach to the issue was rather different, and after assessing the difficulties involved in overcoming the political obstacles to land reform, including ideological positions, the staff had decided not to make it a condition under the program. The staff had however re-emphasized the importance of the issue for bank lending. The issue would, in any case, be pursued further, once the authorities had—as stated in the letter of intent—specified the nature of the revision to the Land Act and proposed that revision to parliament in October of 2002. Once that had happened, the issue of conditionality would not arise any more.

On Mrs. Marinescu's question as to whether the arrears clearance had, in part, been paid by donors, the staff representative observed that budgetary support was, of course, fungible. However, some of the funds provided by the EU had been earmarked for arrears clearance in recent years. Those old arrears stemming from the fiscal year 1999/2000 and the beginning of 2000/01 had been almost entirely cleared. The clearance of the residual amount was a performance criterion for end May 2002. That would remove all arrears. There were additional arrears that had occurred in the early part of calendar year 2001 amounting to about 5 billion Tanzanian shillings—roughly US$5 million—that had not yet been audited. They were being reviewed by the Auditor General, and the government was committed through the letter of intent to clearing those arrears before the end of the current fiscal year.

A more detailed breakdown of priority sector expenditures was desirable, the staff representative agreed, and the authorities had shown as "of which" items the amount for primary education in total education spending and for primary health spending in total health spending. It was, however, expected that the reporting of priority sector expenditures would improve further and that a consistent format would be used for all relevant reporting by the government. It was true that within the priority sectors it should be possible to track items of particularly high priority separately. The authorities had acknowledged that and had begun to do that.

On the interpretation of monetary policy, the staff representative agreed with Mr. Brooke's view that there had been a sizeable percentage increase in private sector credit of 19 percent during 2001. It had, however, been lower than the 24 percent increase envisaged under the program. Also, it was important to keep in mind that credit had grown from a very low base. Commercial bank credit to the non-government sector had increased by 60 billion Tanzanian shillings whereas deposit money had increased by 220 billion. Those were different orders of magnitude in absolute terms, which implied that similar growth rates meant rather different things.

Responding to Mr. Brooke's question about the conversion of non-marketable government debt at the central bank into tradable government securities, the staff representative considered that it was a device to stimulate the secondary market without increasing the amount of government debt.

On the question as to whether the situation of domestic arrears had been a major factor behind the large spreads between loan and deposit rates, the staff representative considered that this was not the case. The factors that the staff had been able to identify were all shown in Box 2 of the staff report. The amount of domestic arrears had not been large in Tanzania, and had been cleared for the most part. Hence, that was no longer a significant factor for spreads between loan and deposit rates, and it was by no means clear that it had ever been one.

With regard to privatization, the staff representative confirmed that coordinating the timetable with the World Bank was part of the staff's agenda. It should be noted that there were no benchmarks relating to privatization under the current PRGF-supported program. However, it had been mentioned in Footnote 5 on Page 8 of the staff report, that the next staff mission would address the issue of the pace of public enterprise reform. Hence, the next staff report would cover that issue, and the staff would collaborate with the World Bank on that.

Concerning Mr. Ralyea's question about the business community's concerns regarding the creation of a land division at the high court, the staff representative remarked that the high court currently had a commercial court, which was much appreciated by the business community. The concerns expressed by the business community vis-à-vis the staff had been that the creation of a land division at the high court might create overlapping or uncertain responsibilities between those two divisions, in particular when commercial cases involved land. The staff had only reported those concerns without making any particular recommendation as to how they should be addressed.

On the safeguard assessment, the staff representative recalled that the previous staff report had laid out all recommendations in that regard. Some of them had related to the central bank's financial year and the rotation of auditors. That would be addressed after the end of the financial year. However, there had not been any controversy with the central bank on implementing those recommendations. The staff would report more comprehensively on that in the next Article IV report.

On the issue regarding the non-Paris Club creditors and the absence of a table in the staff report—one of the questions raised by Mr. Brooke—the staff representative noted that a table containing that information had appeared in the HIPC completion point document, including the country breakdown of the non-Paris Club bilaterals, and the lump sum figure for commercial creditors.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael), addressing the question concerning non-Paris Club creditors, noted that Table 20 on Page 67 of the staff paper on HIPC—Status of Implementation listed all non-Paris Club creditors to the four countries that had currently reached their completion point. For Tanzania the total debt outstanding was US$201 million. Three creditors had already promised debt relief amounting to about US$65 million. Among the remaining creditors Iran, Libya, Yugoslavia, and Iraq were the major ones. One of the lesser creditors had started the process of selling debt in the secondary market, and the Managing Director and the World Bank President had sent a letter advising them of the adverse implications that would have for Tanzania. The staff hoped that it would be possible to convince the remaining bilateral debtors that the regularization of their debt would result in net cash flow to them. That point would be highlighted in the next round of letters that management would send to those countries.

Mr. Mirakhor noted the importance of that issue and added that it occurred in numerous countries. In many cases, the problem originated not at the government level but was under the responsibility of parliament, which had to agree to granting debt relief. It might be useful, if management considered to offer to governments the possibility of having a dialogue with the parliamentarians on those important issues. Proposals by governments to the respective parliaments regarding debt relief decisions often lacked justifications and explanations sufficient to convey the complexity of the issues of the HIPC Initiative and the debt relief from Paris Club and non-Paris Club creditors. Involving the Fund in that dialogue might help accelerate the cooperation of non-Paris Club creditors regarding HIPC debt relief.

The Chairman considered that this was a useful suggestion, but that the practicalities of such a dialogue would need to be carefully specified.

Mr. Rustomjee welcomed the wide support that other Directors had offered for the request for an FSAP. That was an important issue for the Tanzanian authorities. While many members had asked for FSAPs and while there was a limit on how much the staff could do, early consideration should nonetheless be given to that request. Tanzania's financial sector was ready to undergo major further improvements. Therefore, a relatively early FSAP would be extremely valuable.

On the considerations surrounding conditionality regarding the possible changes to the Land Act, Mr. Rustomjee considered that the staff's approach to that should be regarded as model of excellent cooperation between the staff and a member country. It was fully consistent with the approach that the Fund was taking to ownership, and with the overall approach to conditionality. It provided the authorities the space to work through the extremely complex issues, which involved not only the change in the Land Act as such. Rather, the overall objective was a change in the sensitivity of the population to the value that it placed on land. In a country like Tanzania that was naturally enmeshed with major political and historical issues. Therefore, it was extremely difficult to translate that into conditionality about changing a piece of legislation within a given timeframe. The authorities were committed to making changes, and the staff had taken a responsible approach that would deliver results.

Mr. Harzer made the following statement:

We would like to thank the staff for their well-focused report as well as Mr. Rustomjee for his valuable statement. Since we broadly share the staff's assessment and recommendations, we can support the proposed conclusion of the fourth PRGF review, including granting the requested waiver.

Like the staff, we think that the achieved level of macroeconomic stability and the far-reaching debt relief offer Tanzania a good starting point from which to implement the targets laid out in its PRSP. This, however, requires a consequent transformation toward a market-oriented economic policy stance. Against this general background, I have a couple of specific comments.

One fundamental element of such a market-oriented policy is certainly the privatization of land, where, unfortunately, there has so far been no political consensus for the necessary legislative changes. In this context, it is of little help that the structural policy measures summarized in Box 1 of the staff report merely contain general intentions rather than concrete measures. Furthermore, it is regrettable that the list of performance criteria and benchmarks to be fulfilled between May and October 2002 does not presume progress neither in the area of restructuring and privatizing of parastatal enterprises, nor regarding the privatization of land. As a result, major obstacles for more efficient economic activity remain in place.

The expenditure priorities laid out in the PRSP have to be implemented thoroughly in order to reach a lasting effect on poverty alleviation. In our view, a declining share of poverty-related expenditure in total expenditure is not in line with the PRSP's strategy. On the other hand, indications of cutting down non-priority expenditure are lacking, the latter being as important as revenue-generating measures in order to reduce Tanzania's dependency on development aid. In this context, the projected significant increase in military spending is a particular matter of concern.

Like the staff, we welcome the authorities' efforts to improve the management of domestic debt. However, it remains to be seen whether the envisaged legislative change, whereby the government incurring or guaranteeing foreign debt will be made subject to prior cabinet approval, represents as real improvement in terms of better discipline. We encourage the authorities to continue negotiations with non-Paris Club and commercial creditors to realize the remaining 10 percent of debt relief.

The delays which occurred in the provision of poverty-related indicators are regrettable. In particular, the fact that the delayed results of the household budget survey, which were due in February, will be discussed only in September. Unfortunately, the staff report does not provide any information on Tanzania's external debt situation. Monetary policy is challenged by the sharp growth of broad money and the big spread between lending and deposit rates. Against this background, we welcome the authorities' decision to request an FSAP. In any case, the central bank should continue to absorb liquidity by means of open-market operations, and focus its monetary policy on fighting inflation, not least because further growth of broad money must be assumed, given the negative deposit rate in real terms.

The still-high current account deficit is a matter of concern. While progress has been made in diversifying Tanzania's export base, further efforts in that direction are needed. The depreciation of the shilling should not be used by the authorities as an argument to refrain from taking measures that can ensure a durable improvement in Tanzania's international competitiveness. These measures must focus on increasing productivity, as well as on significantly improving the overall investment climate, and have to be supported by further improvements of domestic price stability. The depreciation of the South African rand, which took place in parallel to the shilling's depreciation, makes this task even more critical.

Finally, we welcome the measures taken by the authorities in order to combat money laundering and the financing of terrorism. All this being said, we want to commend the authorities for the progress achieved so far, and want to encourage them to continue their overall good policies, which have helped Tanzania to become one of the best performers in the region.

Mr. Al-Azzaz made the following statement:

I commend the Tanzanian authorities for their strong implementation of adjustment and reform under the PRGF. This is reflected in the observance of all performance criteria and benchmarks except one, which was subsequently completed. These efforts are producing strong results.

As noted in the staff paper, during 2001, growth remained strong, inflation fell further, and external reserves increased. The economy's outlook is also favorable. The challenge at this stage is to build on these improvements and to ensure that the gains are reflected in a speedier alleviation of poverty.

As to the details of the program, I am in broad agreement with the thrust of the agreed objectives and policies. It is essentially a deepening and extension of policies that are already working. What is required now is a full and timely implementation so that the recent gains in policy credibility can take a firm hold. Of particular importance here are continued macroeconomic stability, improved public debt management, and reinforcement of the advances made so far in financial sector reform and privatization. In this regard, the program's emphasis on supporting the implementation of the poverty reduction strategy formulated in the PRSP is reassuring.

I welcome the authorities' increased recognition of the need to shift away from reliance on external assistance to self-help. Indeed, the HIPC Initiative can at best complement the broader domestic policy effort required to achieve the country's development goals.

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

Mr. Bakhache made the following statement:

Tanzania's track record of economic adjustment and reform continues to be strong. The overall performance under the program including the clearance of a larger amount of audited domestic arrears than stipulated under the program, albeit with some delays, is most encouraging. This performance clearly warrants the approval of the requested waiver and the completion of the fourth review under the PRGF.

We are in broad agreement with the policy assessment and recommendations contained in the staff paper and will therefore only underscore certain selective issues, which we believe should be accorded high priority by the authorities.

The economy's outlook remains favorable thanks in large part to the efforts to maintain a stable macro environment and also to the debt relief provided under the enhanced HIPC Initiative. Although foreign interest payment has not changed much following the provision of debt relief, this relief has certainly facilitated the task of maintaining a disciplined fiscal stance while ensuring that social sectors are accorded a priority when allocating resources. This is a welcome development. An examination of the sources of financing of government spending however, continue to show the high dependence of the budget on foreign financing. In fact, over 35 percent of public spending is foreign financed (not including project financing.) This highlights the significance of foreign concessional resources not only for the fight against poverty but also for the maintenance of macro stability. The authorities' steadfast adherence to the economic program certainly shows their appreciation of the economy's need for continued reform and access to international financial support. Nevertheless, the magnitude of foreign assistance needed should spur the authorities in attempting to develop alternative domestic finances.

This dependence on foreign support also underscores the necessity of focusing efforts on improving revenue performance, which is given adequate attention in this review. At around 12 percent of GDP, revenue remains quite low. The recent improvement from 11.3 to 12.2 percent of GDP is encouraging, but further efforts in this area would bode well for the endeavor to reduce dependence on foreign financing. In light of the well-known difficulties associated with increasing revenue, this task is appropriately approached in a gradual manner. We are encouraged that the authorities are looking into ways to broaden the tax base. In this regard, there appears to be ample room to improve revenue mobilization by limiting exemptions.

The staff report appears to downplay the impact of the prevailing low international prices of coffee and cashew on the economy, as other sectors, including tourism, gold, and agriculture, are projected to partly compensate the fall in these prices. These are encouraging developments, but the dependence of the economy on these traditional exports remains large and the impact of low prices should remain under close scrutiny.

Moving to monetary issues, the focus of policy is rightly placed on keeping inflation at a low level. This task has been facilitated by the prudent conduct of fiscal policy and the low domestic financing need of the budget, which has allowed the central bank to contain inflationary pressures without unduly tightening monetary policy. In light of the large growth in liquidity in 2001(M3 grew by 17 percent well above the program target of 13 percent), however, the authorities have to take measures to mop up the accumulated excess liquidity in the market. On the related issue of bank lending to the private sector, we note that credit to non-government sector has been below target throughout 2001, and has stagnated in the last quarter of the year. This may not be surprising given that economic activity has been generally less than envisaged throughout the year. However, this slow growth in lending activity has become more problematic given that banks deposit base has increased without leading to a decline in lending rates. As the staff report points out, this is exposing impediments to bank lending that need to be addressed in a timely fashion. Allowing the use of land as collateral has become more important and we encourage the authorities to take the necessary steps to improve the intermediation capacity of banks.

With these remarks we wish the authorities continued success.

Mr. Skurzewski made the following statement:

Given the overall good economic performance of Tanzania, as well as the efforts made in clearing the domestic arrears, we agree to complete this review and to grant the requested waiver. I would like, however, to briefly touch on a few issues.

On the fiscal side, as mentioned in the letter of intent, the need to increase tax revenue is particularly important, in light of financing development expenditures and to reduce the country's high aid dependency. Any efforts to broaden the tax base are important in this respect. However, the revenue-to-GDP ratio is to remain flat for 2002/03, and this could perhaps warrant an even more ambitious policy stance. I particularly welcome the government's intention to review tax exemptions, as well as the functioning of some parts of tax administration. Perhaps the staff could comment on progress in harmonizing local taxes, which was mentioned during the last review.

On the expenditure side, I would like to commend the government of Tanzania for having protected the allocation of priority sectors in the context of a severe compression of expenditures. I understand from what the staff said earlier that spending cuts have not led to any new arrears in the budget since early 2001. I welcome the increased plan for 2002/03 in the priority sectors. In this context, I also support the decision of the authorities to review the purchase of the new air traffic control system. While I note Mr. Kelkar's concern that this might lead to unnecessary complication of the decision-making process, it is clear that such large capital projects, especially in a poverty-stricken country, require proper budget procedures and transparent procurement. I fully agree with Mr. Brooke and the staff that such decisions should be assessed against the overall priorities of the country.

Regarding the financial sector, I welcome the focus on addressing the obstacles to bank lending. I would particularly like to urge the authorities to look into the issue of the use of land as collateral, which is seen as one of the main impediments mentioned by the bankers themselves. I also note the request of the authorities for an FSAP assessment. However, I wonder if the staff is familiar with the comprehensive study on the financial sector initiated in 2001 and financed by the World Bank and some bilateral donors. This study was supposed to determine the changes needed to strengthen the financial sector, and is, to the best of my knowledge, still ongoing.

Finally, on governance issues, addressing corruption is of high importance, especially in the judicial sector. It would be interesting to learn what has recently been achieved in this area, especially in relation to primary courts. As mentioned in the last review, several anti-corruption plans have been prepared, but we still have difficulties to grasp progress mainly in implementing them. As the publication of the report on the ministerial anti-corruption plans is a structural criterion for the next review, I look forward to more details on these issues in November's report.

Mr. Vogel made the following statement:

At this stage of the discussion, I would like to express agreement with the thrust of the staff appraisal and make a few specific comments for emphasis. First, we welcome Tanzania's performance under the PRGF-supported program with high rates of GDP, low inflation, and other indicators showing a stable political and economic situation. Nonetheless, it is necessary to take into account that these accomplishments are only the preamble to revert the poverty situation in Tanzania.

On the fiscal side, we are encouraged by the authorities' measures on tax administration, even though, as staff report notes, specific attention should be given to reducing exemptions from the VAT. Meanwhile, on the debt management, the formulation of a strategy and timetable for the auditing, assumption and securitization of eligible parastatal debt and other contingent liabilities is welcome.

Keeping in mind the low financial intermediation, it is important to continue the efforts to strengthen the financial system. As Box 2 of the staff report notes, even though Tanzania's prudent financial policies have increased the supply of savings, the commercial banks have had difficulties in lending. We agree with the staff that the authorities need to push hard to amend the Land Act of 1999, which would allow the use of the land as collateral for bank lending. In general, much needs to be done to remove the obstacles in developing this sector. We concur with Mr. Rustomjee that FSAP would be valuable to Tanzania especially at this time.

Turning to other structural reforms, we are encouraged by the authorities' efforts in the area of governance, which will be critical in reinforcing the confidence on economic and social policies. Moreover, it is noteworthy the authorities' commitment in terms of trade liberalization with efforts to reduce the top tariff rate within the East African Community and their intention on the import surcharges.

With these comments, we support the proposed decision and wish the authorities every success in their future endeavors.

Mrs. Boucher made the following statement:

Let me first thank staff for their informative and well focused report. At this stage of the discussion, I would like to focus my comments on a few issues for emphasis:

We join other directors in commending the Tanzanian authorities for their continuous progress and good performance under the program. We welcome the progress in implementation of the PRSP reflected in the increase in priority outlays. We note in particular that development expenditures in priority sectors reached 3.2 percent of GDP in 2000/01 and is projected at 3.7 percent for 2002/03, a level which largely exceeds the level of HIPC debt relief delivered to Tanzania and demonstrates the authorities' strong commitment to poverty alleviation.

On the fiscal stance, in light of the relatively modest increase in revenue to GDP, like other directors, we encourage the authorities to sustain their efforts in this area and aim at more ambitious targets so as to help reduce the country's high dependency on external financing.

We welcome indications in the MEPF on the steps undertaken to redress TANESCO's financial situation and prepare the company for its privatization. We look forward to progress in setting up the agenda for its unbundling while agreeing with Mr. Guetat that the current state of some major foreign operators in this sector might create difficulties and that various options will need to be considered under the guidance of the World Bank.

Finally, on the purchase of the new air traffic control system, we expect the World Bank and the IMF to follow the outcome of the review by the International Civil Aviation Organization and to keep the Board informed. We agree with staff that this case advocates for a more transparent process and closer scrutiny of foreign borrowing. As noted earlier by Mr. Rustomjee, this alone cannot ensure debt sustainability, but it is crucial that both the authorities and the donor community remain vigilant on any new debt extended to HIPC and develop adequate debt management capacity at the country level to try and reach this objective.

With these comments, I confirm our support to the proposed decision and wish the authorities all the best in their endeavors.

Mr. Faircloth made the following statement:

We join other chairs in congratulating the authorities for the strong performance under the program. As we broadly agree with the staff's appraisal and the macroeconomic framework going forward, I will only make a few comments for emphasis.

First, the report takes not of the fact that more progress is needed to secure comparable debt relief from non-Paris Club bilateral and commercial creditors. To that end, we are encouraged by the authorities plans to establish an external escrow account for the debt service owed to these creditors after obtaining appropriated debt relief.

Second, we agree with the program's emphasis on sound debt management, and we are encouraged by the plan to make the contracting and guaranteeing of new foreign debt by the government subject to cabinet approval. On this point, we agree with staff and other chairs on the importance of improved transparency in this context.

Third, strengthening the financial sector is obviously a key a priority, but it will not be an easy task. We certainly welcome the plans to create a credit bureau when financing is secured. However, the sticking point seems to be the issue of land ownership and providing collateral for bank lending. At the Financing for Development Prep-Com in January, it was noted that many African nations have large sums of idle capital that cannot be applied to national development due to restrictive lending environments. This seems to be the case in Tanzania, with obvious implications in terms of constraining economic expansion. We therefore urge the authorities to begin the difficult task of reforming the Land Act to promote a more market-based approach to land ownership.

Finally, Box 2 makes mention of the fact that bank lending is impeded by relatively inflexible labour laws. This reveals a need to increase the efficiency and flexibility of the labour market more generally. Paragraph 23 of the staff report mentions that a new labour law will be introduced to improve the functioning of the labour market – could staff elaborate on the sorts of reforms that will be pursued?

With these remarks, let me again congratulate the authorities on their recent macroeconomic performance. I wish them all them continued success on their future endeavors under the PRGF.

The staff representative from the African Department (Mr. Reitmaier), responding to Mr. Harzer's comment on the increase in military expenditure, considered that, while military expenditure had indeed risen, as was shown in Table 5, the increase from 1.3 to 1.4 percent of GDP was moderate, and the level of military expenditure was extremely low by comparison.

With regard to Mr. Harzer's comment that the staff report did not contain any external debt sustainability analysis, the staff representative considered that, in view of the rather robust debt situation documented in the staff paper on the HIPC completion point in November 2001, it had appeared permissible not to produce an updated analysis at the current stage. The next Article IV consultation report would, of course, contain such an updated debt sustainability analysis.

With regard to Mr. Harzer's remark about a decline in priority expenditures and Mrs. Boucher's comment about an increase in priority expenditure of 3.7 percent, the staff representative noted that both statements were correct, depending on whether they referred to recurrent expenditure or development expenditure. However, overall, priority expenditure had increased over the three years that were shown in the paper. It would be desirable to present a longer history of data on those expenditures, and particularly on the level of development expenditure financed by donors. Work on providing an improved table on that was ongoing, and would be completed once the recommendations on tracking poverty-related expenditures had been incorporated.

On Mr. Skurzewski's question regarding the harmonization of local taxes, the staff representative remarked that, at the current stage, there was only a strategy and a timetable for its implementation. The process was rather difficult, given the number of local authorities and the significant dispersion of types of taxes and of tax rate levels. The thrust of the exercise would be to establish a level playing field and not necessarily to make all local taxes identical across all local authorities. However, the system needed to be more transparent and the elimination of nuisance fees and taxes was important in the context of the strategy.

On the financial sector study, the staff representative considered that the upcoming FSAP that had been requested by the Governor of the central bank would be a joint effort of the World Bank and the IMF, which would ensure that there would be no duplication in that area. There was nothing to add to the information provided on the implementation of the anti-corruption plan. The different ministries concerned were in the process of implementing their respective plans in that regard. Information on progress made in that area should be available at the occasion of the next Article IV consultation.

On Mr. Faircloth's question about the new labor law, the staff representative informed that the intention was to incorporate all ratified core conventions of the ILO, which would lead to a somewhat greater flexibility in hiring and releasing labor, which addressed a concern of the business community. The issue of the admission of expatriate experts and related questions on visas would also be regulated in that context. The staff could provide additional information on that bilaterally.

The staff representative from the World Bank (Mr. Brigish) made the following statement:

> The World Bank's engagement in Tanzania is rather broad-ranging, and our program is among the most robust in the Africa region of the Bank, reflecting productive involvement in most major sectors of the economy. This can be seen in Appendix 2 of the staff report on World Bank relations. We have a large portfolio of some 26 operations. In terms of project execution, the situation is satisfactory and improving further; in terms of policy reform in the major sectors, the situation is characterized by good and improving engagement. In terms of the major pillars of the poverty reduction strategy, education, health, and rural water supplies, our involvement is close and reflects an extremely satisfactory evolution of government policy in these areas.
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> In terms of privatization, I would characterize the situation as slow but steady. The Tanzanian authorities are paying due regard to regulatory issues as they privatize. There have been difficulties in some of the transactions. That is a question of how to do it, and also of how to ensure that, in these very important sectors, particularly the utility sectors, reputable operators and reputable investments can be attracted.

> If there is one recurring issue in our dialogue with the government, it is perhaps transparency in public expenditure, as categorized by the debate about the air traffic control system around this table. I would say also that progress in implementing the anti-corruption program has been slower than we anticipated. The government's continued refrain is the need to respect the rule of law and not to introduce any legal action on the basis of less-than-full proof of corruption.
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> In terms of the future, as is mentioned in the report, we are moving toward the formulation of a Poverty Reduction Support Credit, which reflects the confidence we have in the program. Once all of the budget management and sectoral issues have been satisfactorily addressed, we intend to go forward with that perhaps in the next fiscal year. The thrust of that will be agriculture and rural development, which are sectors in which growth and productivity have been less than expected, and we hope to help the government address some of those issues.
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> The issue of the use of land as collateral is an extremely sensitive political issue in Tanzania. I agree with one of the Directors who reflected the fact that lack of progress in this area has been due to the contentiousness of the question. Our view is that the legislation should provide for adequate disposition of publicly-owned land, particularly in the parastatals in agriculture, whose privatization has been held up because of complications in land reform. We do believe also that there should be movements toward allowing land to be used as collateral for banking transactions. But this, again, is all tied up with the nature of the land and the question in whom the actual title should be vested. This debate in Tanzania is now about three years old and reflects continuing contentiousness in the formulation of the Land Act. We are following this, but it is not something, given the sensitivity of the issue, that we can push with the sort of rigor that we would otherwise wish to apply.

Mr. Ralyea considered that, while the staff's and the authorities' efforts with regard to the issue of the use of land as collateral were appreciated, it would be desirable to include that issue into conditionality going forward. There were good reasons for that. One was that access to credit was a central issue in terms of providing poor individuals, medium-sized enterprises, and large enterprises with the funds necessary to follow through on their plans to grow businesses or even purchase goods such as houses. Also, most Directors had stated that this issue was central for growth and program design in Tanzania. It would, therefore, seem appropriate to cover that with a number of measures under the program. The fact that this had been covered by some measures on the occasion of the last Board discussion also suggested that it was important for the program. While it was recognized that the issue was politically sensitive and warranted a careful approach, as Mr. Rustomjee and the staff representative from the World Bank had pointed out, the staff representative from the World Bank had also noted that discussions on the issue had been going on for three years already. It might not be wise to suggest a date by which the use of land as collateral would become possible.

However, there should be some sort of conditionality—using the term loosely—for those structural measures that could be seen as stepping stones toward the objective of the program. It had been noted that the authorities had the intention to improve the land registry, which was probably not so politically sensitive and seemed to be a feasible measure toward addressing the issue. It should also be noted that there were several chairs showing some disappointment about the fact that the structural measure on the use of land as collateral had been dropped.

The Chairman considered that, while the issue of land reform was particularly important, it also was rather difficult. He would address that question on his upcoming travel to Tanzania. It seemed important to proceed with consideration for the authorities' sensitivities, and he would raise the issue with the president of Tanzania and inquire about his intentions. A gradual approach would probably be the most helpful.

The staff representative from the African Department (Mr. Reitmaier) noted that the Land Act, which had only been passed in 1999, contained a provision quoted in Box 4 of the staff report, according to which all land in Tanzania was public land vested in the President as Trustee on behalf of all citizens. The distance between that provision and a market-based approach to land ownership under which land could be sold, titled, and passed on from generation to generation was large. The staff had not left the authorities in any doubt that this was an issue of the highest importance. Thus the staff had singled that issue out among all the impediments to a more appropriate financial intermediation as being of top importance. Despite the existing land ownership provisions, Tanzania had managed to achieve a creditable performance. While banks and commercial entities in the private sector wanted to see a change, concerns had also been expressed that, once land was used as collateral, the occurrence of nonperforming loans and the consequent seizing of land titles could, over time, lead to a significant concentration of land. That was another aspect of the issue about which the authorities were concerned. However, the staff had insisted on the importance of the issue for improved financial intermediation.

Mr. Rustomjee made the following concluding statement:

> Firstly, let me thank the staff for what I see is a wonderful relationship between our institution and a set of committed authorities, and I hope it will continue in the vein that it has been. It is truly a very good model, and I hope it can be emulated across the membership in low-income countries. I want to thank Mr. Brigish as well for his valuable inputs. Generally, I must say in cases such as this, I much welcome the input of the World Bank during these discussions, and I welcome the inputs that he made.
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> I want to thank my colleagues for not only their written statements, but also their many valuable verbal interventions. I am grateful that they have approved the waiver and the completion of the review. Also, I did want to mention that Tanzania, being a case of a HIPC completion point country, I am pleased that colleagues have recognized what great value achievement of the completion point can afford to a country that is committed to continuing with

its reform efforts. I think this is a very good demonstration of that. I hope many more countries that are committed can come to the completion point quickly.

I am grateful that colleagues have recognized the sound overall performance of the authorities, notwithstanding the global downturn that has been experienced at least several months ago. On the fiscal issues, I have taken note of the many comments of colleagues on the need to improve tax administration, reduce exemptions, improve VAT collections, and I will take all of that back to the authorities.

I am pleased that some colleagues have noted the extraordinary efforts the authorities made in making sure that priority expenditures were protected, notwithstanding the compression in expenditure—a very significant compression in the last year. That is a demonstration of the authorities' strong commitment to maintaining their efforts to protect priority expenditure areas. I have taken note of the various comments of colleagues on the clearance of domestic arrears. I did take note of the comment on the significant increase in military expenditures; I will take that back to the authorities. I think a valuable response has been given by staff on that already.

The comments on the implications of the delayed household survey, I will take back to the authorities as well, and also the comments on the generalized need to better prioritize government investments and improve public expenditure management systems. All of that I have captured, and they will be aware of that. On the financial sector, I do welcome the many comments of colleagues. I found valuable the comments of Mr. Kelkar and Mr. Mirakhor about the issue of financial deepening in Tanzania and broadening of the financial sector there, and I will take that back.

I am grateful for the willingness of Board colleagues to consent to Tanzania's participation in an FSAP; I do think that will be valuable for them. I have taken note of the comments about developing the micro finance sector and also the need for reducing impediments to bank lending, and I will touch a bit upon that in just a moment. I welcome the proposal from one colleague about developing the credit bureau.

On poverty-related issues, I did note the point by Mr. Brooke, who mentioned that income distribution has been uneven, notwithstanding good growth performance, and also the need for the more efficient use of the household survey data in the next PRSP review. I think that will be valuable not only to Tanzania, but more broadly. It will help improve our understanding of the linkages between growth and poverty reduction, which is what Mr. Brooke had suggested. I think it was him also who mentioned the issue of the authorities conducting a routine debt sustainability analysis, and I am sure that they will be committed to doing that on an ongoing basis; it will be valuable for them.

I did want to pose the hypothetical question that, if the debt sustainability analysis revealed that debt was unsustainable in a post-completion point case, it is moot as to what they would have to do to get themselves back on a sustainable track, if the reason why they went unsustainable was an exogenous factor, because there is no provision in our current HIPC framework for post-completion point cases where debt sustainability is prejudiced by exogenous factors. However, I think the ongoing effort will be valuable for them and, more broadly, for post-completion point cases generally.

There was an acknowledgment that the authorities are trying to link the expenditures in PRGF, PRSP, and HIPC, and synchronize them. They are very committed to doing that. I imagine that this will probably be the first member that succeeds in getting that synchronization right across the entire membership. I think that probably even includes Uganda. However, that is going to be a very difficult task to accomplish on an ongoing basis. Sometimes all three will fuse; sometimes they will start drifting apart, as systems reveal themselves to contain challenges. Nonetheless, it is a valuable exercise, and they are committed to doing that on an ongoing basis.

On structural reforms, colleagues had many comments. I will take all of those back. Firstly, on the privatization issue and the generalized intention of the authorities to ensure that through this process they reduce reliance on budgetary support. I did want to thank Mr. Mirakhor for his comment in his statement that the authorities need to stand ready to make adjustments if contingent liabilities arise through the course of their privatization. I think this is valuable advice to the authorities, which I will take back to them.

The land issue is indeed complex, and it is certainly a complex issue for the authorities. It is going to take some time, for a fully adequate resolution of the issue. It is certainly an issue of great political sensitivity. I did want to mention that the land issue is part of what is being raised in the context of the Fund Board discussion as a broad issue of how to improve credit allocation in the economy so that financial intermediation can be improved and, of course, savings can be channeled to productive investments. One of the reasons why I say it could take time is because the authorities have embarked on a program which really started about ten years ago, and which was their first step to financial sector liberalization. I did want colleagues to consider the background here. The authorities went through a massive restructuring of their banking sector starting around 1992. They had one state-owned bank, if I recall correctly, that held 97 percent of the deposits of the banking sector. They have gone through a process where they have now 12 commercial banks, 20 micro finance institutions; three of them are state-owned, and the remainder are now in private hands. There is now a large foreign banking participation in the economy whereas ten years ago there was neither domestic commercial banking sector activity, let alone private sector activity.

As colleagues have pointed out, domestic savings are being mobilized now. The extent of deposit mobilization has been very significant compared to a period five or ten years ago. Their challenge now is how to apply these savings to productive investment, and this is where the land issue is starting to come in. The authorities have had a long sequence of steps in their financial liberalization process, and they are now starting to meet the challenge which colleagues are identifying. I am recalling that process because the authorities are indeed very committed to breaking through all these barriers step by step. They are fully aware of what is required; it is just that these things take time.

The branch network of these private commercial banks is expanding right now and going out of the city areas, into partly-urban and then into rural areas. This is an additional reason as to why the importance of changing the land tenure arrangements has become very clear to the authorities.

On labor market rigidities, I think this is valuable advice for the authorities. Mrs. Marinescu and many others have mentioned this point, and I will take that back to the authorities, particularly the recommendation that they do not simply follow the statutory retrenchment requirement of one month, or rather that they do not simply keep it on the shelf and offer 12-month retrenchment packages, but try to stay as close to that statutory minimum as possible.

I did want to mention one other structural issue, which came up in the context of the discussion about the depreciation of the currency and the recommendation that this should not be used as an excuse for not implementing structural measures. That is valuable advice. It could be quite easy for any set of authorities to rely on a substantial depreciation to avoid structural changes. The authorities in Tanzania are mindful of these options. They tend to prefer to address the structural challenges, improve productivity, and keep on with structural reform. But it would be valuable for me to reiterate that to them.

There were a few other comments, and I want to assure my colleagues that I have taken all of those on board, and I will reflect all of those to them in the statement to my authorities. My final comment is on the issue of ongoing quarterly reports of the local authorities' budget. I think this is a demonstration of the very strong commitment of the authorities. I think that it is extremely challenging to be able to produce such reports on an ongoing basis. It must be a very onerous and severe task to do this at the local level. One can imagine how it would work at the national or at the state government level, but at the local government level, to be producing these quarterly reports, demonstrates how far Tanzania has come.

The Chairman considered that Tanzania's case was a success story. While there was always room for further improvement, it was also clear that the authorities had a strong commitment to do so. Mr. Rustomjee had noted that there was a particularly good relationship between the staff and the authorities, and the staff should be commended for that. It was important for the staff to combine sensitivity to a country's situation with candor of the advice given, and that seemed to have been the case in Tanzania.

The Chairman made the following summing up:

Executive Directors commended Tanzania for the continued strong implementation of macroeconomic policies, which has helped to further promote robust growth, reduce inflation, and strengthen the external position. They also welcomed the completion of sectoral strategies for education, agriculture, and rural development, which target high-priority areas of the Poverty Reduction Strategy Paper; and looked forward to the second progress report on the PRSP later this year, incorporating an updated poverty analysis.

Executive Directors welcomed the good performance of tax revenue so far in fiscal year 2001/02, which occurred despite a shortfall in value-added tax collections. Nevertheless, they stressed the need to mobilize additional government revenue in order to reduce Tanzania's dependence on external assistance. They therefore urged the authorities to forcefully implement their revenue plans, especially to reduce tax exemptions and strengthen tax administration.

Directors welcomed the completion of an inventory of all domestic debt, and endorsed the efforts underway to formulate a strategy and timetable for the auditing, assumption, and securitization of eligible parastatal debt based on this inventory. Directors welcomed the authorities' efforts to strengthen public debt management, especially by subjecting the contracting and guaranteeing of new foreign debt to cabinet approval. They urged the authorities to implement the necessary policies to try to ensure that post-HIPC external debt sustainability is maintained.

Directors welcomed the authorities' emphasis on good governance as an element of their strategy to pursue economic growth and poverty reduction. In this regard, they emphasized that the selection and financing of large investment projects should be subject to a transparent review process. They also stressed the need for improvement in the transparency of fiscal management at the local level, such as through the publication of quarterly expenditure reports.

Directors noted that reform of the state-owned electricity company is expected to gradually reduce the company's dependence on budgetary support. They urged that other public utilities be similarly reformed.

Directors supported the proposed increase in allocations for poverty reduction programs in the budget for 2002/03, but stressed the need to track outlays in priority areas and record donor-funded project expenditure. They encouraged the authorities to continue to implement the medium-term civil service pay reform, which is aimed at improving motivation and governance in the civil service, but to curb superfluous government employment.

Directors considered that monetary policy in 2002/03 is being appropriately tightened to contain inflation and further build up reserves. However, they noted the impediments to bank lending, especially the inability of borrowers to use land as collateral. Reform of land ownership laws was seen as crucial for stimulating investment, as was the need to harmonize prudential and tax regulations concerning loan loss provisioning by banks, improve the land registry, strengthen the commercial courts, and finalize microfinance regulations. Directors supported the authorities' request for an early financial sector stability assessment.

Directors welcomed the authorities' commitment to reducing the top customs tariff rate in the context of the forthcoming East African Community trade protocol, and to eliminating the surcharges imposed in last year's budget on several categories of imports.

The Executive Board took the following decision:

1. Tanzania has consulted with the Fund in accordance with paragraph 2(ee) of the three-year arrangement for Tanzania under the Poverty Reduction and Growth Facility (PRGF) (EBS/00/44, Sup. 1, 04/06/00) in order to review program implementation and reach understandings regarding the phasing and conditions for disbursements during the third year of the arrangement.

2. The letter dated March 29, 2002 from the Minister for Finance of Tanzania (the "Letter"), together with the attached Memorandum of Economic and Financial Policies for 2002 of the Government of Tanzania (the "Memorandum"), is attached to the three-year PRGF arrangement for Tanzania, as already supplemented and modified, and the letter dated March 9, 2000 with annexed memorandum shall be read as supplemented and modified by the Letter and the Memorandum.

3. Accordingly, the three-year PRGF arrangement for Tanzania shall be amended as follows:

a. in paragraph 1(cc) “During the second year of the arrangement” shall be deleted and replaced with “During the arrangement” and “July 31, 2002” shall be deleted and replaced with “November 30, 2002”,

b. a new paragraph 1(ddd) shall be added as follows:
“(ddd) the conditions for disbursement of the seventh loan under the arrangement shall be established in the context of the fifth review of Tanzania’s program with the Trustee as contemplated in paragraph 2(ee).”

c. Paragraph 2(a) shall be amended to read as follows:
“Tanzania shall not request the disbursements referred to in paragraph 1(cc) above,

(a) If the Managing Director of the Trustee finds that with respect to the fourth disbursement, the data as of March 31, 2001; with respect to the fifth disbursement, the data as of September 30, 2001; and, with respect to the sixth disbursement, the data as of June 30, 2002 indicate that:

(i) the ceiling on the net domestic assets of the Bank of Tanzania, or

(ii) the ceiling on the net domestic financing of the government of Tanzania, or

(iii) the floor on the net international reserves of the Bank of Tanzania, or

(iv) the ceiling on contracting or guaranteeing of external debt on concessional terms,

as set out, with respect to the fourth disbursement, in Table 1 of the letter dated February 24, 2001, and with respect to the fifth disbursement, in Table 1 of the letter dated August 31, 2001, and as further specified in the TMU attached to the letter dated August 31, 2001, and with respect to the sixth disbursement as set out in Table 1 to the Memorandum attached to the Letter dated March 29, 2002 were not observed, or”;

d. a new paragraph 2(cccc) shall be added as follows:

"(cccc) If, with respect to the sixth disbursement referred to in paragraph 1(cc) above, the Managing Director of the Trustee finds that Tanzania has not carried out its intentions with regards to:

(i) the clearance by May 31, 2002, of T Sh 15 billion of audited domestic arrears accumulated during the period July–December 2000, as set out in paragraph 3 of the memorandum attached to the letter dated March 29, 2002 and its Table 3; and

(ii) the announcement by July 31, 2002, of a timetable for the complete elimination of the suspended duties (import surcharges) in 13 product groups introduced in the 2000/01 budget, as set out in paragraph 26 of the memorandum attached to the letter dated March 29, 2002 and its Table 3; and

(iii) the submission to parliament by October 31, 2002, of legislative amendments which require cabinet approval of the contracting or guaranteeing by Tanzania of any new foreign debt, as set out in paragraph 16 of the memorandum attached to the letter dated March 29, 2002 and its Table 3".

4. The Fund decides that the fourth review contemplated in paragraph 2(ee) of the three-year arrangement under the PRGF for Tanzania is completed and that Tanzania may request the fifth disbursement under the arrangement, notwithstanding the nonobservance of the December 31, 2001 structural performance criterion on the clearance of audited domestic arrears specified in paragraph 2(cc)(ii) of the arrangement, on the condition that the information provided by Tanzania on the performance under this criterion is accurate. (EBS/02/56, 3/29/02)

Decision No. 12721-(02/41), adopted
April 15, 2002

2. SRI LANKA—STAND-BY ARRANGEMENT—REVIEWS, EXTENSION, AND WAIVER OF PERFORMANCE CRITERION

Document: First and Second Reviews Under the Stand-By Arrangement and Requests for Waiver of Performance Criterion and for Extension of the Arrangement (EBS/02/59, 4/1/02)
Staff: Carter, APD; McGuirk, PDR
Length: 1 hour, 25 minutes

The staff representative from the Asia and Pacific Department (Mr. Carter) submitted the following statement:

> This statement provides an update on recent economic developments and financing issues since the staff report was issued on April 1, 2002 (EBS/02/59). The information contained in this statement does not alter the analysis or the appraisal in the staff report.
>
> The 2002 budget, which was approved by Parliament today, is in line with the program framework. Because of technical complications, the new VAT will become effective from July 1, 2002, a delay of one month.
>
> The latest consumer price data show that the trend of inflation continues to decline. While the Colombo Consumers' Price Index (CCPI) increased by about 0.50 percent in March, the Colombo District Consumer Price Index (CDCPI), which covers a wider geographical area and has more current weights, declined by about 0.75 percent. Both indices continue to show a gradual deceleration on an annual average basis. The decline in inflation is closely related to the decline in food prices, reflecting a gradual improvement in supply conditions.
>
> The latest information on gross official reserves indicates that the level has been stable since late March. As of April 8, 2002, gross official reserves (expressed in market prices) amounted to about US$1.2 billion. The rupee is currently trading at Rs 95.8/US$1 and has slightly depreciated against the dollar and other trading partner currencies since late March 2002.
>
> The monetary policy stance continues to be tight. The data on reserve money at end-March 2002 suggest that the program's end-April reserve money target is likely to be observed. The Central Bank of Sri Lanka raised its key overnight reverse repo rate by 20 basis points to 13.85 percent on April 4, in response to an increase in banks' demand for funds from the reverse repurchase window ahead of the mid-April Sinhala and Tamil new year festival. Other rates have also increased slightly—for the week ending April 5, the 3-month treasury bill yield was 12.9 percent, compared with 12.7 percent at late March, while the prime lending rate was 14.0 percent, compared with 13.6 percent at late March.
>
> On financing issues, the authorities and the World Bank staff have reached broad agreement on the policy framework for the Private Sector Development (PSD) credit. The program loans from the AsDB are also broadly on track. While a few details of the US$130 million PSD credit have not yet been completely finalized, it is expected that the Bank's Operations Committee would discuss an Initiating Memorandum in May. An appraisal mission is scheduled for June and the first tranche of the PSD credit (at least 50 percent) could be released by the third quarter of 2002. Although the SBA-

supported program itself, which runs through mid-August, is fully financed, the timing of disbursement of the PSD credit would affect the post-program balance of payments prospects. Any financing gap for 2002 arising from a delay into 2003 of the remaining PSD credit disbursements could be filled by a combination of further policy adjustment and additional financing from other sources.

The program assumes the current WEO oil price projection of US$23 per barrel for 2002. However, if the recent increase in oil prices continues, it could add additional pressure on the balance of payments.

Mr. Jayatissa submitted the following statement:

The Fund-supported economic stabilization program launched in 2001 was successful in preventing a major balance of payments crisis. The reserve decline has been arrested. Performance criteria for end December 2001, except the target for net credit to government from the banking system, were observed. The performance under the program needs to be judged in the context of an unexpected and sharper deterioration of the domestic and external market conditions during the second half of the year. The Sri Lanka economy suffered severely from four major shocks which came on top of the global economic slowdown. These were: an attack on the Colombo International Airport in July 2001, a highly unsettled political situation which led to a dissolvement of the parliament and fresh elections in December after the People's Alliance lost its majority, the September 11 events, and a severe drought.

The domestic political situation has now improved considerably, with a more reform oriented party, the United National Front (UNF) gaining the majority in the parliament after December elections. The recently held provincial council election results reinforced an overwhelming majority support for the UNF. The new government is firmly committed to restore peace and implement major economic reforms. They have already made major strides in the peace process by signing an indefinite ceasefire agreement and are planning for negotiations for long-lasting peace. The new government has initiated major economic reforms, with the announcement of the budget 2002. The budget was passed by the parliament on April 11. It is encouraging that my authorities have now put in place measures to bring the program back on track and to address many remaining structural weaknesses currently impeding a sustained high growth in the medium-term.

Recent Economic Developments

In the wake of major demand and supply side shocks, which were beyond my authorities control, the economy contracted last year for the first time since gaining independence in 1948. The real GDP declined by 1.3

percent in 2001 because of the high degree of openness—with exports and imports of goods and services accounting for 85 percent of GDP—the country's external vulnerability remains high. Exports, excluding services, which accounted for about 30 percent of GDP declined by 8 percent in real terms and imports which accounted for about 40 percent of GDP declined by 11 percent. Tourist arrivals and earnings from tourism declined by 16 percent. The private sector confidence eroded sharply and the investment ratio declined by about 5 percentage points of GDP in 2001. The overall investment declined to 22 percent of GDP from an average of 27 percent of GDP during the last three years. On the supply side, output of all major sectors, agriculture, manufacturing and services declined mainly due to the drought and power cuts. The telecommunications sector however continued to grow strongly.

There were continuing pressures on the consumer price index, largely due to the sharp increases in administered prices of diesel, kerosene, furnace oil, LP gas, transport fares and electricity tariffs in 2001. Food price increases due to drought and depreciation of the rupee also exerted price pressures. However, as the staff has pointed out, the inflation trends were broadly in line with the program expectations, particularly as the monetary program was kept under tight control.

The performance targets for reserve accumulation, external debt and external debt arrears were met. Inflows of foreign exchange to the central bank through market purchases increased, following the move on to the free float, in January 2001. The central bank purchased US$127 million on a net basis in 2001 and has purchased a further US$52 million during this year so far.

The economic activity has started to pick up particularly in the services sector (mainly transport and domestic trade in goods and services) with some recovery in exports as well. Opening up of roads to war affected areas in the North and East and free movement of goods and people are expected to make a positive contribution to GDP growth this year. Given Sri Lanka's high trade dependence, the more positive outlook for the global economy would enhance the growth prospects for the country. The GDP growth in 2002 is expected to be in the range of 3.5-4.0 percent. When the supply side starts responding to the recent improvement in market sentiment, a further easing of inflation is envisaged during the second half of the year.

Fiscal Policy

The overall fiscal deficit exceeded the original budget target by 2.3 percent of GDP in 2001 while there was some unfortunate pre-election fiscal loosening, the increase was largely due to the circumstances that the country had to undergo during the second half of the year. Revenue shortfall due to the slowing down of the economy alone accounted for nearly 60 percent of the slippage compared to program expectations.

The authorities have taken several bold measures to strengthen macroeconomic stability and address major structural weaknesses. The first budget of the UNF administration introduced both revenue enhancing and expenditure containment measures, aiming at an overall fiscal deficit target of 8.5 percent of GDP. The measures which have been summarized in the staff report Box 2, includes, on the revenue side, merging of the National Security Levy (NSL) into the GST through a dual rate VAT, while also bringing many exempted items into the tax net, simplification of the income tax system while giving broad future direction for corporate tax rate, harmonization of two different tax regimes and bringing all tax incentives under revised Inland Revenue Act, elimination of stamp duties while bringing in a debit tax, and several other measures.

Measures for tight control of expenditures also have been introduced including special attention on security-related spending. My authorities are also looking forward to using the forthcoming fiscal ROSC to improve monitoring and control. Budget also expects to protect essential social expenditures. On the expenditure side, the budget envisages cuts in both current expenditure as well as unproductive capital expenditures. Expenditure savings are also expected through improved debt management, including through a reduction of high cost overdraft facilities. In addition, a contributory pension scheme for new public sector employees has been introduced to help contain the rising pension bill in the longer term.

My authorities are also very conscious of the need to realize the privatization receipt projection in the budget. To that end Public Enterprise Reform Commission has already started on the preparatory work to sell shares in the state telecom company and a large insurance company, while moving forward on several other sales that has been earlier envisaged.

Public Corporations

The Ceylon Petroleum Corporation (CPC) which had very large losses in 2000, was able to make profits in 2001 to lower their debt. To prevent a recurrence of losses, they introduced a formula for flexible pricing of petroleum products to be in line with world market prices and exchange rate variations. The formula also includes a debt recovery component, through higher excise taxes. The budget also announced the elimination of CPC’s monopoly and liberalize the imports and supply of petroleum products.

The performance of the Ceylon Electricity Board (CEB), was severely affected by the drought and serious capacity constraints. The water levels of the major hydropower reservoirs declined to 12 percent of full capacity and the power generation had to rely heavily on thermal power. As short-term measures to address the growing imbalance of power supply/demand situation and reduce operational losses, electricity prices were raised by an average of 35 percent with effect from April 1, 2002. For household consumers who use more than 180 units, the tariff increase was about 75 percent. To address the supply and longer term problems in the energy sector, steps are being taken to restructure the CEB with a view to unbundle generation and distribution of electricity. The private sector is now actively involved in the power sector business and some projects have already been commissioned.

Monetary and Exchange Rate Policies

The central bank kept the monetary policy reasonably tight through control of reserve money and using repo and reverse repo rates as major signaling instruments in open market operations. The indicative targets for reserve money and the performance criterion on the central bank's net domestic assets (NDA) were observed comfortably. Growth of broad money was broadly in line with the program. The private sector credit growth was somewhat lower than in the program, reflecting high real interest rates and the slow down in economic activity. The public sector, both budget and state enterprises, continued to be the major borrower from the banking system. This is being addressed in the revised program. The electricity price revisions and the flexible pricing of petroleum products would help to contain state enterprise debt levels in 2002.

With improved stability in the foreign exchange market under the independently floating regime the repo and reverse repo rates were lowered from 18.5 percent in early April to 12 percent during April and October 2001, and the reverse repurchase rate from 21.5 percent to 14 percent. The decision to reduce these policy interest rates also reflected the authorities serious concerns about the sharp slowing down of economy during this period. These two policy rates today are 11.50 and 13.85 percent respectively and have been made more flexible than before. The authorities expect to move on to more active open market operation following recent FSAP mission and with TA from MAE.

The floating exchange rate system introduced in January 2001 has served the country reasonably well. The exchange market has become more stable and the exchange is relatively stable around 95-96 per US$1. The authorities are committed to maintain the open and liberal foreign exchange market with any interventions limited to maintain orderly exchange market conditions. The temporary precautionary measures introduced with the shifting to the floating regime have been further relaxed. Accordingly, in July 2001, the 25 percent deposit requirement on forward foreign exchange contracts was withdrawn. With effect from August 17, the restriction on pre-payments of import bills were removed. With effect from March 1, 2002 the limit on net open position of commercial banks have been converted to prudential requirement and raised to 15 percent of capital and reserves and limit on the duration of forward market contracts were extended to one year.

Other Structural Measures

My authorities are concentrating on structural reforms in the financial sector, public enterprise restructuring, and privatization and labor market reforms. They have also removed the exchange control restrictions foreign investments in construction of residential buildings, roads, water supply, mass transportation, telecommunication, professional services, banking, finance, insurance, stock broking, production and distribution of energy and power and establishment of liaison offices of companies incorporated outside Sri Lanka. In order to help the government with state bank restructuring, World Bank/IMF Technical Assistance mission has been scheduled for May 2002. While the AsDB has already providing support to strengthen structural reforms, a private sector development credit from the World Bank to support my authorities structural reforms is expected at the beginning of the third quarter, based on reform measures have been or are being implemented in the area of land, labor market, public enterprises and state bank restructuring.

Safeguard Assessments

The central bank acknowledges the importance of appropriate accounting, auditing and risk management. In that context, it has is implemented the major recommendations of the stage two Safeguard Assessment Reports and soon will complete remaining actions in this area.

PRGF

Sri Lanka is planning to embark upon a PRGF arrangement later in 2002.

My authorities would appreciate the support of the Executive Board for Sri Lanka's requests for a waiver of the performance criteria for end-December 2001 on net credit to government of the banking system, completion of the first and second Reviews under the SBA and a two months extension of the programme.

Mr. Yagi and Ms. Saito submitted the following statement:

General Comments

Since the Stand-By Arrangement was approved by the Board last April, Sri Lanka has been exposed to a severe environment of weak world economic growth, made worse by the events of September 11, as well as the bombing of Colombo International Airport. It has also experienced a change of government and with it a disruption in program implementation. The government has, however, expressed its willingness to resume the program, and we commend the efforts that have been made by both the authorities and staff to bring the first and second reviews to the Board. The task ahead is not an easy one, however, and in order achieve the objectives of the program it will be necessary for the authorities to assume full ownership of the program and implement it with strong resolve.

External vulnerability has declined somewhat since the program began because of the floating exchange regime and the increase in international reserves. Looking at Sri Lanka's economic situation today, however, we see that growth is negative, the budget deficit is much higher than projected under the program, and the authorities are far from achieving the initial objective of stabilizing the economy. Also, structural reforms have lagged behind because of the elections. It is therefore important, as the authorities themselves recognize, that during the remainder of the Stand-By Arrangement they concentrate on stabilizing the economy, while building a foundation that would enable them to tackle comprehensively the issue of poverty reduction, which could provide the grounds for a possible PRGF arrangement.

Fiscal policy and debt management

The poor fiscal performance may have been mainly a result of the steep decline in economic activity, which was largely due to exogenous factors. However, it is still a matter of concern that the fiscal deficit rose to 10.8 percent of GDP, thus missing the target by 2.3 percent. For Sri Lanka, curtailing the deficit is essential to compressing the public sector debt, which is now over 100 percent of GDP. This will reduce interest payments and in turn free funds for poverty-reducing social spending. The 2002 budget calls for simplifying the tax system while expanding the tax base and, on the expenditure side, freezing civil service wages and curtailing military expenditure, as well as cutting subsidies. These measures will help to reduce the budget deficit to 8.5 percent. Box 2 of the staff paper, which describes how much each measure will contribute to the budget, is particularly helpful. It is noteworthy that on the revenue side, the national security levy will be abolished and the GST will be expanded. Even though the size of the adjustment is apparently greater than envisaged in the original program, it is vital that this adjustment be made in order to put fiscal consolidation on a firm course. The authorities claim that they have exhausted high quality measures that are politically feasible and that it is difficult to identify additional contingency measures. If that is the case, then it is all the more important that the measures stipulated in the budget are implemented firmly, so that there is no slippage.

Concerning the financing of the budget deficit, the report mentions that the deficit will be filled by external aid flows and asset sales. The authorities should try not to resort to expensive sources of financing if these inflows do not materialize. It is therefore important that debt management be strengthened, and from this perspective it is appropriate that the statutory debt limit was amended to encompass all government debt, and to have a global debt limit.

Structural reforms and private sector development

In order for Sri Lanka to achieve 6.0 percent growth in the medium term, it is essential to foster and strengthen the private sector, starting with the implementation of structural reforms that will improve the investment environment. More concrete and detailed structural reform measures should be identified in conjunction with the PRSP now being developed, and through discussion of a PRGF program; however, it is important that the present program provide a head start. We think it is appropriate that this program includes an action plan for the restructuring of two large state banks as a start to more comprehensive banking sector reform. Concerning the Ceylon Electricity Board, in addition to improving its financial situation, it is important to enhance operational efficiency. This would include reforming the regulatory framework, which would contribute to providing a reliable power infrastructure, vital for a strong and competitive industrial sector.

On the privatization of state enterprises, staff advocates that this should take place expeditiously. However, it is important to understand that privatization depends to a large extent on prevailing market conditions, and is prone to various uncertainties that may arise as preparations for the sale unfold. Therefore, while we recognize the importance of keeping the momentum for reform, it may not be appropriate to rush with privatization and possibly compromise aspects such as transparency and accountability. Needless to say, efforts to ensure accountability should not be used as an excuse for the authorities to unduly delay necessary privatization.

With these remarks, we support the proposed decision and wish the authorities success in their future endeavors.

Mr. Guinigundo submitted the following statement:

Key Points

Sri Lanka continues to suffer from adverse political and economic developments, however, the new government has indicated its commitment to pursue the objectives of the program.

With all performance criteria having been met, with the exception of the fiscal target, and all prior actions having been implemented, we support the request for the completion of the delayed first and second reviews under the SBA and the waiver on the fiscal target.

The Sri Lankan authorities face the difficult challenges of achieving peace, preventing fiscal and quasi-fiscal slippages, and vigorous implementation of key structural reforms in the financial sector, public enterprises, privatization and the labor market.

It is important to recognize the risks to the program, notably the success or the failure of the peace process and those circumstances which are beyond the control of the authorities.

Sri Lanka suffered from adverse political and economic developments that literally derailed the program with the Fund during the second half of 2001. The new government has indicated its commitment to restore life to the program. All performance criteria were met with the exception of the fiscal target on net credit to the government by the banking system, while all the prior actions have been carried out.

On this basis, we support Sri Lanka's request for the completion of the delayed first and second reviews under the SBA and request for the waiver for the non-observance of the fiscal performance criterion. It is also necessary that the disbursements be rephased and the life of the arrangement be extended by two months.

With this support, we also address the challenges, risks and program monitoring and design facing the authorities in the immediate future.

Program Challenges

Attaining national peace has been an elusive dream for Sri Lanka. Recently, it has been reported that the government and the leaders of the Tamil Tiger rebels will be conducting peace talks in Thailand. This is a very significant step in the right direction. Cessation of hostilities will buy time and the opportunity for Sri Lanka to focus their efforts on economic stabilization. While there will always be uncertainty on the final outcome of these peace talks, we remain optimistic that these initial steps could lead to improved prospects.

It is also important for Sri Lanka to prevent the fiscal and quasi-fiscal slippage in 2001 from recurring this year and beyond. The challenge is quite formidable considering the actual budget deficit exceeded the program by a full 2.25 percentage points of GDP. There was a shortfall in public revenues due to weak economic activity; an overrun in public expenditures owing to higher subsidies, defense spending and interest payments; and slippage in credit to public corporations due in part to a failure to adopt a market-oriented pricing mechanism, and in part to operational inefficiencies.

We therefore support the authorities' move to rationalize the GST and NSL into one value added tax, simplify the income tax structure and import duty regime and to move away from the temporary surcharges imposed in 2001. Sri Lanka will also benefit from a prudent public expenditure program. With better prospects for peace, it is now possible to reduce security-related spending. With better global economic prospects, it is advisable to rationalize public enterprises. In this connection, we wonder if there is any scope for reducing the reportedly large locked-in expenditure items? We also support the long-term goal of reducing the civil service and restructuring of the pension system. The authorities should be commended for ensuring that the basic social safety nets are kept intact, notwithstanding the fiscal stance to reduce public expenditures.

We support the authorities' decision to introduce an automatic petroleum pricing formula before the end of last year. More important, we also find it interesting that the staff also supported the authorities' plan to restructure CPC, divide refining, sell off the large fleet and filling stations this year and bring down foreign exchange borrowing. This approach will also be applied to other public sector entities including the port, railways and the postal department. Is it the plan to restructure CPC and then later privatize, or does the program call for a simple restructuring? Staff clarification would be appreciated.

On monetary policy, while we agree with the staff on the need to keep a cautious stance until such time that fiscal consolidation is more firmly established, we have some difficulty understanding the staff's recommendation to publish the reserve money program and progress in meeting these targets. We could understand this recommendation if the historical data on the target and actual reserve money levels are made public. However, publishing next month's targets on reserve money, for instance, might limit the flexibility of the authorities' open market operations and unnecessarily increase their borrowing cost. The other point is the staff's suggestion for the CBSL to refrain from moral suasion. Emerging foreign exchange markets have the kind of dynamism and complexity that should warrant the greatest flexibility on the part of the authorities to undertake appropriate measures, including moral suasion, to ensure an orderly foreign exchange market.

The other challenge is to see a more vigorous implementation of the structural reform agenda in the areas of the financial sector, public enterprise restructuring and privatization and labor market. With the new government's commitment, we are optimistic that some good progress will be seen in laying the groundwork for a more sustainable growth in the Sri Lankan economy. The authorities must be reminded that achieving the structural reform objectives of the program is one opportunity that will be most costly to miss.

Program Risks

There is no doubt the main risk to the program is the durability of the peace process. We do not want to go into this political question; we could only hope that the new leadership will be able to muster sufficient political will and support to pursue a broad-based peace program.

There are other risks beyond the control of the authorities. To the extent that the global economy remains weak and political opposition, as well as capacity constraints, slow down policy implementation, the success of the program could only be limited. It will be useful if the authorities could take the necessary steps to broaden the support of the civil society to enhance program ownership and implementation. Technical assistance is also essential.

Mr. Mirakhor submitted the following statement:

Key points

We support completion of the first and second reviews under the SBA.

Fiscal consolidation should be the focal point of the stabilization program.

We support the authorities' request for a fiscal ROSC.

A tight monetary policy remains appropriate until the economy stabilizes.

We welcome the authorities' commitment to a floating exchange rate.

Vulnerabilities identified by the FSAP need to be addressed expeditiously.

Structural reforms should be accelerated for sustainable higher growth and poverty reduction.

Assuming credible performance, Sri Lanka should make a smooth transition to a PRGF arrangement later this year.

We thank the staff for a well-written report, and Mr. Jayatissa for his helpful statement. Against a background of adverse domestic and external shocks, macroeconomic performance was mixed in 2001 under the Stand-By

Arrangement. On the positive side, monetary and external policies in Sri Lanka were on track, inflation was broadly satisfactory, the external current account deficit narrowed, along with a build up of reserves, and the exchange rate was relatively stable. Less propitiously, the real economy contracted for the first time since independence, program fiscal targets were missed, and structural reforms delayed. The new government, while facing daunting economic and political challenges, has made a commendable start by passing a 2002 budget aimed at stabilizing the economy and moving forward with structural reforms. The recent signing of a ceasefire agreement with the LTTE, with the expectation of formal talks in a few months, has improved the climate for policy making and has bolstered business sentiment. We concur with the thrust of the staff appraisal, and, in view of the authorities' renewed commitment to bring the program back on track, as evidenced by completion of all prior actions, support the proposed decision.

To reverse the rising trend of the fiscal deficit and public debt, there is an urgent need for a strengthened policy framework and meaningful fiscal consolidation. Central to this endeavor will be enhanced revenue mobilization, combined with expenditure restraint and rationalization. We welcome the various revenue and expenditure measures in the 2002 budget, which appear to be broadly in line with the contours of the recent FAD technical assistance report. On the revenue side, efforts to simplify the tax system, broaden the tax base and curtail widespread exemptions, harmonize the tax incentive regime, and phase out the import surcharge should help increase transparency and efficiency of the tax system. In this context, we note the merging of the NSL into the GST, and join the staff in stressing the need for the Inland Revenue Department to administer the changeover efficiently. We also attach special importance to the steps taken to strengthen tax administration. On the expenditure side, measures to limit transfers, freeze the wage bill, and constrain security-related spending should facilitate fulfillment of the authorities' commendable commitment to maintain social spending. We welcome the newly appointed monitoring committee on security-related spending and support the authorities' request for a fiscal ROSC. Plans to ensure better targeting under the Samurdhi social safety net are encouraging, and we look forward to the early enactment of a new Welfare Benefit Law.

A tight monetary policy remains appropriate until the economy stabilizes, inflation declines, and reserves increase to comfortable levels. Greater reliance on active open market instruments consistent with monetary targets should now complement the notable progress made in enhancing the transparency and credibility of the CBSL's monetary framework. On exchange rate policy, we note the authorities' continued commitment to a floating exchange rate and to an intervention policy limited to dampening excessive volatility and bolstering reserves. Given the initial favorable experience with the floating regime, efforts should now focus on improving the functioning of the interbank foreign exchange market. On the financial sector, given the rise in non-performing loans, we welcome plans to deepen state bank reform, and strengthen banking supervision. We encourage the authorities to expeditiously address the vulnerabilities identified by the FSAP mission to guard against systemic problems that could erode public confidence in private banks.

Sustainable growth and poverty reduction could only be achieved if macroeconomic stability is combined with an acceleration of structural reforms. Given the constraints of implementation capacity, however, we see merit in the staff's suggestion to concentrate on a core set of policy actions, critical for both macroeconomic stability and promotion of private sector-led growth. While recent price adjustments have improved the financial position of key public enterprises (CEB and CPC), their planned restructuring promises to deliver durable improvement in efficiency and attract private participation. Assuming favorable market conditions, the authorities' privatization program envisages a number of transactions which need to be completed without further delay. An overhaul of labor legislation is also necessary to facilitate job creation, and improve the environment for private enterprise. In this context, we welcome the forthcoming regulatory change aimed at facilitating greater labor mobility.

Finally, we note the authorities' intention to incorporate the full structural reform strategy into Sri Lanka's PRSP, due to be completed by June 2002, and hope that, with solid implementation under the SBA, Sri Lanka will make a smooth transition to a PRGF arrangement later this year.

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

Sri Lanka's economic performance in 2001 suffered from a number of exogenous shocks contributing to a mixed policy implementation record, particularly in the fiscal area. Thus far in 2002, the external environment has shown some improvement, and the new government confirmed its commitment to economic reform by implementing strong prior actions in the context of the approved budget as pointed out in the well-written staff report and Mr. Jayatissa's informative statement. Given these welcome and determined actions, we support the completion of the first and second reviews and the request for extension of the commitment period. As we are in broad agreement with the staff's appraisal, we will limit our comments to a number of core policy issues in the fiscal and structural reform areas.

Sri Lanka's fiscal policies over the last few years have been characterized by sizable deficits, peaking at some 10.0 percent of GDP in 2001, and leading to the accumulation of a large public debt. Revenues declined modestly in relation to GDP from their already low level, and expenditure continued to edge up. Moreover, the structure of both revenues and expenditures has also been less than optimal. Surcharges and emergency taxation constituted a considerable part of revenues, while expenditures were dominated by non-priority and non-productive outlays, while interest payments and transfers and subsidies accounted for about 7.0 and 5.0 percent of GDP respectively. In view of the weak public finance structure, we support the program's emphasis on achieving an improvement in the fiscal position based on high quality and sustainable measures as well as well-focused structural reforms which should contribute both to the fiscal effort and to improve the medium-term growth potential.

With regard to revenue measures, we welcome the authorities' intention to eliminate the National Security Levy and to adopt a broad-based VAT system with only two rates. These measures, as well as the harmonization of the tax incentive regime and the phasing out of import surcharges, will go a long way in simplifying and rationalizing the tax system while increasing revenue on hopefully a more sustainable basis. This effort should be complemented by improving tax administration through enhancing tax registration and audits, strengthening the large taxpayer unit, and merging the different revenue agencies in one unified department.

On the expenditure side, the authorities are to be commended for their decision to limit transfers and freeze the wage bill, especially after the wage increase of last year. This decision, along with other expenditure cuts, is projected to result in a significant decline in total expenditures despite the envisaged increase in interest payments. At the same time, it is encouraging to note that the basic social safety nets will be protected, and that the budget introduces objective criteria to rationalize and enhance the targeting of subsidies

Achieving the 2002 fiscal targets is most important to enhance confidence and induce a virtuous circle of declining interest rates and debt service, which would in turn help put the overall deficit on a downward trend while creating room for increasing expenditure in priority areas. It is therefore crucial to strengthen expenditure control, including in public corporations, and identify sufficient contingency measures in case fiscal revenue falls short of projections. In this connection, we would encourage the authorities to avoid re-instating poor quality adhoc measures such as emergency surcharges and, instead, aim at speeding up the removal of the large subsidies to public institutions.

Making solid progress in privatization and improving public debt management, including by refraining from the use of costly overdraft borrowing, are also essential to help achieve medium-term fiscal sustainability. In addition, the new automatic price adjustment mechanism for petroleum products, which incorporates a debt-recovery component, should help reduce budgetary transfers and enable the public monopoly to repay its large bank loans. We also commend the recent considerable increase in electricity tariffs to more realistic levels. The plans to restructure the public monopolies in these two important sectors, and to change the regulations to allow private sector participation, would go a long way in improving efficiency and attracting much needed investments.

Finally, we urge the authorities to implement the recommendations of the FSAP in order to improve the health of the banking sector. In this connection, we welcome the recent decision to increase the capital requirements for commercial banks. It would also be important to carry out a comprehensive review of the loans portfolio of banks and increase provisioning as needed. Furthermore, we encourage the authorities to phase out directed lending and to develop a strategy to address the problems in the two large public sector banks with the assistance of the World Bank and MAE. In the meantime, it would be important to base any new lending to public enterprises on sound economic and financial basis in order to limit a further deterioration in the loan quality and the resultant contingent fiscal liabilities.

Mr. Barro Chambrier submitted the following statement:

At the outset, I would like to thank the staff and Mr. Jayatissa for his informative and helpful preliminary statement.

In 2001, Sri Lanka's macroeconomic performance under the Fund program was mixed due to a number of factors, among which drought and political stability. While inflation was contained at low levels, growth performance contracted by more than 1.0 percent. However, it was encouraging to read that the implementation of Fund-supported program helped the country to halt the drop in official reserves, and the current account deficit narrowed. In addition, at end-June 2001, the program had met all its key objectives. Nevertheless, the situation remains fragile, and important challenges lie ahead. I therefore welcome the authorities' commitment to adopt prudent financial policies and push ahead their reform program for 2002.

I concur with the staff's appraisal and I support the proposed decision including the waiver for nonobservance of performance criteria for end-December 2001, completion of the first and second reviews under the Stand-By Arrangement, and the proposed two-month extension.

In the fiscal area, the overall deficit rose by 1.0 percentage point to almost 11.0 percent of GDP owing to a decline in revenue and fiscal laxity in the run-up to the December 2001 elections. Moreover, government debt has risen to more than 100.0 percent of GDP. The key challenge facing the authorities is therefore to establish fiscal sustainability. In this regard, I welcome the measures envisaged under the 2002 budget. On the revenue side, I note with satisfaction that the authorities will simplify the tax system, eliminate widespread exemptions, adopt a VAT with a substantial broadening of the base, and adopt measures proposed by the FAD technical assistance. The harmonization of the tax incentive regime between the Board of Investment and the non-Board Investment companies under the Inland Revenue Act is also an important measure that will improve tax administration, enhance transparency, and governance. I also welcome the phasing out of the import surcharge, which should lead to an improvement in efficiency and to competitiveness. On the expenditure side, the measures to limit transfers, freeze the wage bill, and constrain security-related spending are commendable. In addition, I welcome the longer-term plans to address the high wage bill and tackle rising pension costs while protecting basic social safety nets. However, the large size of the public sector represents a key constraint on the fiscal stance. Fiscal sustainability will hinge on the authorities' ability to tackle this constraint and implement concrete actions to downsize the public sector and alleviate its financial burden on government revenue.

In the monetary and exchange areas, the authorities should be commended in achieving the program's monetary objectives in 2001 through a tight control of reserve money. However, as the fiscal stance is a concern, I share the staff's view that monetary policy would need to remain tight. It is reassuring to note the progress made to implement MAE's recommendations in order to improve the transparency and credibility of the central bank's monetary framework and enhance the effectiveness of policy instruments. In this regard, I note that the flexible exchange rate has worked well and the initial volatility of the rupee was contained, while most administrative controls have been removed. However, the functioning of the market is still weak I therefore welcome measures being taken to promote a more active interbank market while maintaining normal prudential foreign exchange exposure limits.

On the structural front, progress was less satisfactory due to delays in implementing reforms in the areas of tax policy and tax administration. In addition, the removal of remaining restrictions on FDI flows was delayed. I therefore welcome the structural reform agenda, which the government has designed for 2002. However, I share the staff's recommendations that the program should focus on critical areas that will improve conditions for sustainable growth. These areas include financial sector, public enterprise restructuring and privatization, and labor market reform. On financial sector reform, I am pleased to note that the authorities intend to restructure the two state banks and address the banking system vulnerabilities by increasing the capital requirements for commercial banks and developing a regulatory policy for handling weak banks. On public enterprise restructuring, I welcome the government's action to reform Ceylon Electricity Corporation as well as the restructuring of the Ceylon Petroleum Corporation. In the same vein, the authorities' efforts to promote private sector development through the disengagement of the state from major public enterprises are commendable. It is an important step towards private sector led growth. However, the success of this strategy will depend on the status of labor market in particular flexibility of labor. In this regard, I welcome the authority's actions to facilitate labor mobility.

With regard to the Safeguard Assessment, the authorities should be commended for considerable progress made in implementing recommendations by Fund's staff. Indeed, important priority measures have already been taken and I welcome staff's indications that the remaining measures will be taken by year end.

Mr. Rustomjee submitted the following statement:

We thank the staff for a comprehensive report and Mr. Jayatissa for his detailed and helpful preliminary statement. Since we are in agreement with the thrust of the staff report and their recommendations, we shall limit our comments to a few issues for emphasis and ask staff for clarification on an issue raised in their appraisal.

Although Sri Lanka's macroeconomic performance, as measured by GDP, fell below the programme target, the authorities are to be commended for their impressive performance in regard to the programme conditionality under the SBA supported programme. Indeed, the mixed results on the macroeconomy resulted from exogenous economic factors outside their control, such as external shocks and domestic drought. The authorities are to be commended especially in the areas of reversing the trend of external reserve losses, making the recently introduced exchange rate float workable and effective as well as maintaining a broadly prudent monetary stance.

We are also impressed by the spirit in which the new government took up the challenges, not only of continuing with the SBA programme in spite of the fact that it was initiated by a previous regime, but also addressing the outstanding challenges by treating them as prior actions for the completion of the first and second reviews. In this regard, we welcome in particular, the corrective measures being undertaken in the 2002 budget as well as the policies set out in the Medium-term Economic and Financial Programme (MEFP) and the Technical Memorandum of Understanding (TMU) to stabilize the economy and address the outstanding challenges. We also note the resolve of the authorities to take any additional measures considered appropriate by the Fund for the purpose of achieving the desired objectives.

Nonetheless, we encourage the authorities to step up the process of addressing the outstanding structural reforms in the areas of rationalizing the operations of loss-making state enterprises, simplifying the income tax and import duty regimes, and implementing policies that will engender the promotion of private sector-led growth. Furthermore, we note that important challenges remain in government's fiscal operations, especially with regard to the significant fiscal deficit, which resulted largely from uncontrolled expenditures on defense, subsidies, pensions and other welfare schemes. The need for the authorities to adhere to the fiscal targets becomes pertinent in view of the critical importance of fiscal consolidation to achieving prudent monetary programme in the short-term, which in turn is expected to enhance the growth of private sector credit and increase the contribution of the sector to the country's economic growth. However, we are pleased to note that with the 2002 budget, the authorities have started demonstrating their commitments in some of these areas of reform as well as in focusing the capital budget on key donor-financed projects.

Finally, we would welcome staff comments with regard to the issue raised in paragraph 49 of the report. The staff have recommended that, to provide incentives for some target sectors, it is preferable for the authorities to provide lower corporate tax rates rather than the new tax exemptions announced in the budget. While we see some merit in the staff's approach, it would be useful to better understand in what way will its implementation be to be an improvement on the authorities' proposals in terms of transparency and being appropriately applied to the target sectors?

With the impressive performance of the authorities on structural benchmarks and their strong commitment to the programme, we support the request for waiver of the non-observance of the performance criterion and an extension of the programme.

We wish the authorities the every success in their future endeavors.

Mr. von Kleist made the following statement:

I thank the staff for their well-written and candid report and Mr. Jayatissa for his informative preliminary statement. In the run-up to our last discussion one year ago, Sri Lanka was struggling to avert a balance of payments crisis. The decline in international reserves has since been halted. However, the broader stabilization goals of the Fund-supported arrangement were clearly missed. In particular, Sri Lanka's difficult fiscal position has become even more, rather than less precarious. It is unfortunate that the sizeable risks of the program that were identified during our previous discussion have actually materialized. In retrospect, the program assumptions may have been on the optimistic side. Looking ahead, we attach all the more importance to the reform commitment of the new government, as evidenced by recent undertakings on the fiscal and structural side. The recent progress in the security situation has also improved prospects for fiscal consolidation and reform. It is on this basis that we are willing to support today's decisions.

However, given the mixed success of the program so far, we would have welcomed more stringent targets going forward. I shall come back to this later. In addition, I shall briefly comment on fiscal, monetary and exchange rate policies.

Firstly, on fiscal policy, the crucial task of restoring a sustainable fiscal position has regrettably been complicated further by the recent sizeable slippages. The staff report leaves little doubt that there are clear risks that the fiscal goals might be missed again. Both budgetary savings and privatization revenues might fall short of expectations. The authorities must not hesitate to take offsetting actions if needed, and it is not very encouraging that they see little room for implementing such measures on an economically sound basis. In this connection, it struck me that there are no savings from the restructuring of public utilities listed in the otherwise very useful Box 2.

On exchange rate policy, we encourage the authorities to further improve the functioning of the interbank market and to try to refrain from interventions altogether.

On structural reform, the ongoing pricing adjustments in the petroleum and the energy sector will lend some financial breathing space to the CPC and the CEB, which should be utilized wisely. The planned removal of entry barriers in these markets is an important step. It will, however, place further pressure on the profitability of public corporations. Moreover, the staff note that the CPC and the CEB have deep-seated problems of overstaffing and bad management. Addressing these problems and completing the restructuring of these corporations by early 2003 will therefore be challenging. The staff's assessment of the prospects for achieving this goal on time would be appreciated. As regards the state banks, given their size and their weak non-performing loan and capital asset ratios, restructuring of these entities is rightly a core element of the structural program.

Turning to conditionality, the decision to exclude the reform of the energy and petroleum sectors from structural conditionality may be acceptable from the point of view of streamlining. But it appears all the more important that the targets that have been included actually be met. We would therefore have preferred upgrading one or two structural benchmarks to performance criteria, for instance the benchmark on bank reform and/or on finalizing reports on public sector transactions. As regards the important fiscal sector and the related quantitative targets, the number of performance criteria has not been raised under the revised program. I understand, however, that the changes in the definition of performance criteria will, in the staff's view, strengthen monitoring of the program.

Finally, I would like to add that the performance under the revised program should also be a factor weighing heavily on the discussions of a successor arrangement under the PRGF. Having said that, I wish the authorities every success in pursuing their dual task of securing economic reforms and a lasting peace for their country.

Mr. Ralyea made the following statement:

We abstained on Board approval of the program in April 2001 because envisaged reforms were weak and, against the backdrop of a civil war, risks to program implementation were extremely high. Events proved that our concerns were well-founded. The SBA was off-track during most of 2001. This year, the situation appears more promising. The new authorities have signed an indefinite cease fire with the Tamil Tigers. If the cease fire leads to a political solution to the civil war, one of the major factors undermining economic reform would be removed. In the meantime, the authorities have indicated a desire to begin implementing much needed reforms.

Lax fiscal policies were the main reason for weak program performance in 2001. The previous authorities failed to meet all four indicative targets related to fiscal performance as well as the lone fiscal performance criterion. The fiscal deficit grew to almost 11.0 percent of GDP. Policy choices accounted for the fiscal slippage. Pre-election tax cuts, failure to implement any of the expected improvements in tax administration, and current expenditure overruns equal the amount by which the fiscal deficit target was missed. Public-sector debt now exceeds 100.0 percent of GDP.

The high level of public debt argues strongly for rapid tightening of fiscal policies. To their credit, the new authorities are taking some steps in that direction. This year's budget, if implemented fully, will result in a three-percentage points-of-GDP improvement in the primary deficit. The tax changes included in the budget are welcome, though the authorities' decision to grant new tax holidays, against the staff's advice, tempers our enthusiasm. We also share the staff's view that bolder efforts are needed to reduce the size of the public sector. Speeding up removal of subsidies to public institutions, as the staff suggests, would be a good place to start.

On the financing side, we caution the government once again on relying too much on uncertain privatization receipts as a fiscal financing source. Should those receipts fail to materialize, as they have for at least the past four fiscal years, the debt-to-GDP ratio will likely be higher than expected and a return to fiscal sustainability further delayed. At the same time, the program assumes that external financing will pick up sharply on the back of growing investor confidence. We strongly encourage the authorities to offset any shortfall in privatization receipts or external financing with cuts in current expenditures.

Reform and privatization or divestiture of state-owned enterprises is the other major disappointing area. Here again, we see some evidence that the new authorities are willing to take tough decisions to reform these enterprises. In particular, the 35.0 percent increase in administered energy prices in April is a welcome step. The fact that the increase was insufficient to cover CEB's operating costs demonstrates how in need of reform the public enterprises are. Indeed, the staff concludes that electricity and petroleum enterprises are overstaffed and badly managed. We look forward to the complete restructuring of CEB and CPC by early 2003, if not sooner. We also welcome the authorities' willingness to consider a radical restructuring of Peoples Bank and labor market reform. We will be looking for evidence of actual reforms in the coming months.

With poor performance last year under the program, it is no surprise that reserve accumulation, the main objective of the SBA, fell well short of program targets. The authorities have made good efforts to revive the old program. However, given the lack of ambition in that program and poor implementation, we would have preferred that the authorities and the staff would have scrapped the program and started afresh with a stronger SBA-supported program. In paragraph 43, the staff indicates that pursuit of a more ambitious structural reform agenda is possible and desirable to spur growth. As it is, we expect near flawless implementation of the current SBA before the Board is asked to complete the final review. We also expect that any follow-on PRGF arrangement for Sri Lanka would include credible prior actions in the fiscal and structural areas and targets designed to reduce Sri Lanka's debt overhang and spur private-sector led growth.

Given the stated commitment of the new authorities to restart the reform effort and some positive actions in that direction, we support the proposed decision. In particular, we appreciate the staff's suggested retranching. Finally, we appreciate the excellent coverage of the safeguards assessment in the staff report and urge the authorities to consent to publication of the report.

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

On the fiscal situation, as stressed in the staff report, the 2002 budget is tight in the sense that there is no room for slippage, and the staff have impressed upon the authorities that they need to take actions straightaway to achieve all their various targets. It was asked whether further tightening could be achieved by addressing locked-in expenditure items. The wage bill, the pension bill, and the interest costs constitute the bulk of locked-in expenditure items, and even with a major commitment to staff reductions, few savings would be achieved for 2002. There is a complete commitment not to increase wages and new positions, and the staff have worked with the authorities on ways to reduce the interest bill, but there is not any real room to reduce these items below what is stated in the staff report.

On corporate tax incentives, the staff have suggested to the authorities to try and create as level of a playing field as possible. The authorities' position is generally favorable in eliminating holidays for special companies. Once the staff accepted that the authorities were going to continue with some tax incentives, the staff considered accelerated depreciation allowances as a first step. Sri Lanka, however, already has a relatively generous system already for all companies, so we advocated lowering the tax rate rather than giving a complete holiday. Lowering the tax rate reduces the cost of the incentive, and also brings these companies and projects into the tax net. One of the problems is that if companies are not paying any taxes at all, reporting issues arise. Generally, the staff does not see the incentives that have been announced in the budget as being major in terms of revenue losses.

Several Directors raised the authorities' reliance on privatization proceeds in financing the budget. It is true that the authorities have come up short in the past, which is why for this year the staff did not suggest adding projects which had not been considered previously. All the asset sales that are lined up for financing the budget have been in progress for sometime, and the staff would try and make sure that the authorities are taking actions over the next two or three months to ensure the sale of those entities scheduled by the end of 2002. There has been progress on some of the smaller items, and a shift in approach; the authorities are more mindful of criticism about transparency. Sale of the bigger items will be handled through the stock market as much as possible, and that is why the staff have placed benchmarks on preparing for sale of both the state telecom and the insurance company, which are the two main items.

Outside the formal budget, there have been questions raised about the performance of Ceylon Petroleum Company (CPC) and the Ceylon Electricity Board (CEB). The CPC improved its financial performance significantly last year; it actually made profits, and was able to reduce its debts by about SRPs 6 billion. The government is heavily committed to reforming the CPC. One approach is that the authorities are changing the law to remove monopoly powers and other legal restrictions. They are then breaking up the business into several categories, and will bring in private participation. Relatively soon, the authorities will begin to dispose of the petrol stations and the tankers, and they are already calling for signs of interest in the storage facilities. So far this year, new staff have been placed in the CPC, including financial advisors from outside.

The electricity board's losses were large last year, and the staff report cites mismanagement and misorganization. In all fairness, the drought situation has to be taken into account. According to the latest numbers, 80 percent of power generation is currently from thermal sources, whereas the CEB normally expects 50-60 percent from hydropower. As a result, the CEB is incurring some large immediate costs, which hopefully will be reduced as the drought reduces. The increase in electricity prices was not designed to make the electricity board profitable immediately, especially considering the current rather dire situation. The price increases are meant to create an underpinning for their financial situation for the whole of the year. At the same time, the government is breaking up the institution. It will take time, and hopefully will be achieved by early 2003. Again, legal steps need to be taken to amend the electricity bill, so as necessary to dissolve the state monopoly.

On the state banks, while the People's Bank is in need of major reform, the Bank of Ceylon is making profits, has reasonable capital adequacy, and is trying to improve. The People's Bank has a more fundamental problem of negative net worth, which for the first time they officially revealed in their published accounts. The Prime Minister is keen to take a drastic action to reform this institution, and sought the Fund's and Bank's technical assistance. The Fund and Bank will return on mission in 10 days time to work out options.

The other issue that was raised was a question on the military expenditure targets and the outturns by Mr. Guinigundo. The authorties are trying to act upon the work of the FSAP mission and their report, a summary of which will be provided in the staff report for the Article IV. The Central Bank of Sri Lanka is quite transparent in its information; it reports reserve money estimates on a weekly basis with only a one-week delay. The staff also had support from the private sector when on mission in Colombo. They asked the staff to put pressure on the central bank to come out and say what their targets were and how they were achieving them. The staff thought this to be a good indication.

Finally, it was asked why the staff was arguing against moral suasion in the foreign exchange market. The staff agrees with Executive Directors that an orderly foreign exchange market may indeed need the use of various measures. Our main concern was that it not go beyond that, and that the central bank should not put pressure on the market to steer the direction of the rupee.

Mr. Guinigundo commented that moral suasion should be applied in cases where there was possible speculation in the foreign exchange market to maintain stability. There were certain cases where speculation was harmful to the stability of the foreign exchange market, and the flexibility to use moral suasion should be available to the authorities in addressing any future potential pressure on the foreign exchange market.

Mr. Pereyra made the following statement:

I thank the staff for a well written paper and Mr. Jayatissa for a very helpful preliminary statement. We would like to recognize the new authorities' commitment to bringing the SBA back on course after the significant implementation problems experienced in 2001. We welcome the fiscal consolidation policies and structural reforms the authorities intend to implement to achieve macroeconomic stability and lay the foundation for a sustained private sector-led growth. The authorities' initiative to curb the civil conflict, as reflected by the treaty signed in February, should also be commended. The ambitious revenue and expenditure policies involved in the 2002 budget reflect that the authorities resolve to tackle the fiscal slippage of 2001.

On the revenue side, we would like to highlight the commitment to streamline the tax structure and rationalize the wide-ranging and complex system of tax incentives. Concerning the former, we agree with the staff that even though the merging of the NSL and GST into a two-rate VAT is a move in the right direction, it would have been desirable to adopt a single-rate VAT for the sake of administrative simplicity and economic neutrality. Also as noted by the staff, the harmonization of the tax incentive regime under the revised Inland Revenue Act will contribute to transparency and equity. However, we would recommend the authorities to further revise the tax incentive structure in the future as a way to achieve a tax system that would be broader based, more uniform, and would not distort resource allocation. Additionally, we support the authorities' stated intention to phase out import surcharges for specific agricultural goods, but have reservations regarding the new tax holidays because of their negative effect on tax collections.

On the administrative front, we commend the authorities for the implementation of improvements in tax registration, tax audits, and the large taxpayer unit in line with the FAD recommendations. Substantial work lies ahead to bring down the still sizable fiscal deficit of 8.5 percent GDP in 2002. The authorities are encouraged to build consensus around the need for strong fiscal adjustment through measures such as a wage freeze, yearly personal deductions, and a switch to fully funded civil service pension scheme. Social programs are being preserved and their effectiveness enhanced through better targeting, notably in the Samurdhi scheme. However, as rightly noted by the staff, the achievement of fiscal sustainability will rely significantly on additional aid inflows, improved debt management, privatizations, fiscal discipline, and not least, consolidation of the peace process.

Concerning structural reforms, we welcome the implementation of the price adjustment mechanism for CPC and the introduction of a tariff raise for CEB as well as the proposed legal changes to promote competition in the energy sector and the completion of deregulation of foreign direct investment.

We agree with the staff that the state bank reform and the introduction of policies to address commercial bank weaknesses should be given utmost importance.

Regarding privatization, we encourage the authorities to complete the legal framework to allow achievement of their divestiture objectives for 2002, which would not only contribute to more competitive environment but will also eliminate the fiscal burden imposed by subsidies to state-run firms. We would also like to associate ourselves with the staff, the Bank, and AsDB on the need to underpin private sector growth through legislation aimed at enhancing labor market flexibility.

We congratulate the authorities for the commitment to monetary discipline and the planned publication of the monetary program and the periodical progress report which will greatly contribute to the public's understanding of the inflation objectives of the Central Bank of Sri Lanka. After the successful introduction of a free floating regime, we concur with the staff that the way is paved for further improvement in the foreign exchange market. The steps taken by the authorities merit recognition, and therefore we support the granting of the requested waiver, the completion of the first and second reviews, and the proposed two-month extension. We also expect that following the current SBA, a PRGF arrangement will support a medium-term program of critical reforms based on the PRSP that we encourage the authorities to complete this year.

Mr. Macia made the following statement:

During the course of 2001, Sri Lanka faced several unforeseen and extremely difficult economic and political conditions, which impaired its growth potential as well as its full commitment to the Fund's supported program. Despite the terms of trade deterioration, the effects of the drought, and the civil unrest that took its toll on tourism, this country complied with all end-2001 performance criteria except net credit to government by the banking system. We noted also that the floating exchange rate system has proven effective despite the initial volatility threat dissipated by prompt action by the CBSL and commend the authorities for the measures adopted to improve the adequate functioning of the foreign exchange market. As monetary policy has been tightened, money growth remains in line and reserves targets have been met. Inflation was subdued within the program's levels, and remains in a declining trend. On the other hand, the signing of the ceasefire accord should help to avert future civil conflict, and it is a necessary social and political preamble to pursue major economic reforms imbedded in the program.

It is envisioned that 2002 should bring real output to a stronger stand with improved agricultural conditions and power supply, higher investments and external financing, and a strengthened private sector participation as confidence and political stability sets in. The program aims at a stronger fiscal stance under a new VAT effort, a strengthened tax administration, and a clamp on subsidies. Notwithstanding, the overall fiscal balance continues to be large, and we would urge authorities to reassess the net benefits on the tax incentives extended for large infrastructure projects. We appreciate the staff opinion that there would be no major revenue losses with the measures taken for the medium term. We also consider that wages and salaries, transfers to enterprises, and security-related outlays should be closely monitored during the year to avoid slippages given the existent political pressures, and the large locked-in expenditures that may affect budget performance. Though social outlays remained protected and a fully funded pension fund format is envisioned shortly, we concur with the staff that the issue of the tax-exempt salaries of civil servants must be dealt with promptly.

While many challenges remain ahead, we welcome the proactive thrust of the authorities to push ahead reforms. We are encouraged with the envisaged corporatization of electricity generation and distribution, the elimination of its monopoly in supply activities, and the steps to bring private sector expertise into other public enterprises. Privatization must move ahead in telecommunications, insurance and others, as well as the selling of shares owned in gas and oil enterprises. The restructure of the two state banks, and the progress noted with the implementation of the Safeguards Assessment measures have strengthened the effectiveness and confidence of the financial sector. We expect perseverance on the pending issues to be in place in the next few months.

We are also pleased to note that the authorities have taken swift decisions in various fronts. They moved decisively to implement the automatic petroleum formula, the recent electricity tariff increase, and have removed the obstacles to foreign direct investment flows. They have also used prudence in establishing statutory limits on domestic public debt, and are in the process of implementing labor laws to improve labor mobility. The authorities should remain vigilant to debt management, primarily in relation to the use of overdraft facilities and foreign currency commercial borrowing as has been advised by the FSAP missions and clearly stated in Mr. Jayatissa's detailed preliminary statement. We trust such vigilance and determination endures the pending reforms and measures at hand.

With these comments, we concur with the staff's recommendations on continued Fund support, the completion of the first and second review under the Stand-By Arrangement, and the extension request. We commend the authorities for the remarkable efforts to tackle the challenges at hand.

Mr. Taylor made the following statement:

A year ago when we first discussed an SBA for Sri Lanka, this chair was among those that held the view that fiscal issues were central and that the public sector deficit and fiscal consolidation had to be the focus of attention as the essential first step towards any medium-term reform program. One year on this remains our view. We are pleased to see that the new government's budget in March 2002 has put fiscal stabilization as the prime objective. Box 2 of the staff report provides a useful summary of the budget's key features, and commitments to protect spending on health and education, and the intention to control security-related spending through the establishment of the defense spending monitoring committee, are welcome. We also welcome the agreement by the authorities that net domestic financing of the budget should become a performance criterion under the program. While these measures presented in the 2002 budget demonstrate the new government's commitment to fiscal consolidation, this ambitious agenda will have to be sustained through a difficult period. Programmed fiscal targets depend heavily on external economic conditions, and there is little room for maneuver. As the report states, contingency measures are limited. Implementation, therefore, will be key to both achieving the medium-term growth outlook and any transition to a successor PRGF arrangement. As the authorities clearly recognize, the costs of not taking action are large, not least the negative implications for the debt dynamics. The key structural reforms focus appropriately on public enterprise and financial sector restructuring and labor market reforms. Again, Box 3 of the staff report provides a useful summary of the coverage of structural conditionality, and in particular we noted staff comments on the relevant structural conditions which are not included in the current program but which might be included in a future one.

We welcome the government's efforts in preparing its PRSP and its scheduled completion in June, and the intention of incorporating a broad structural reform agenda into the document. We stress the importance of maintaining a broad participatory approach in the PRSP process in order to ensure wide ownership of the PRSP objectives.

We believe the key development since the approval of the SBA in April last year has been the recent improvements in the prospects for a negotiated solution to the civil conflict. The staff have appropriately pointed out the significant economic potential a final resolution of this conflict would bring through higher investment and improved business confidence. Thus, we support the completion of the first and second reviews for the extension of the arrangement, and for the granting of the associated waiver on a performance criteria, and wish the authorities well.

Mr. Djojosubroto made the following statement:

We thank the staff for a well written report and Mr. Jayatissa for his helpful preliminary statement. We commend Sri Lanka's government for their efforts to balance the budget, to keep monetary aggregate under control, and the exercise of floating exchange rate regime aimed at achieving internal and external balances.

The challenges faced by Sri Lanka's economy in 2001 cannot be underestimated. As a result of political disturbances, combined with the severe drought, and the impact of the global economic slowdown, GDP declined for the first time since independence, and the inflation rate increased to a two digit level. These unfavorable developments have not only hampered the implementation of the program under the SBA but also worsened the overall financial position of the government. We welcome the recent peace initiative to resolve the long-standing problem of civil conflict, and we hope that peace will last forever. This will enable the new government to concentrate their efforts and resources on the economic reform program and create a positive rate of growth and employment in the economy.

We broadly agree with the staff appraisal, and concentrate mainly on the issue of public financing of structural reforms. One of the most challenging tasks for the new Sri Lankan government is to consolidate the fiscal position to sustain growth and stability. However, resolving the problem of the fiscal deficit, which presently is around 10 percent of GDP, is not an easy job. The authorities need to increase revenue, combined with prudent expenditure management, so as to enhance medium-term fiscal sustainability. Revenue position of the government has remained weak due to the severe economic slowdown and tax cuts during the election period.

The tax system remains complex with widespread exemptions. In this context, the authorities' intention to raise the revenue by 1 percent of GDP in the near term seems ambitious. However, we encourage the authorities to remain vigilant in broadening the tax base and simplifying their procedures so as to strengthen the revenue in the medium term. Although the intention of granting a limited tax holiday is understandable, the effectiveness of such a measure is considered less worthy than providing investment certainties through good and transparent economic regulations.

On the expenditure side, the task is more challenging as the authorities expect a decline in spending by 0.5 percent of GDP in 2002 through various measures, such as restraining the civil service wage bill and improving the overall public expenditure management system. Since the government debt has increased to more than 100 percent of GDP, interest payments have been the largest spending component in the government expenditures. We therefore recommend a prudent debt management policy and urge the authorities to seek concessional external financing as far as possible. In this vein, we suggest that the authorities consider the possibility of entering into a PRGF arrangement with the Fund.

The most difficult problem faced by the government is related to the expenditures in relation to borrowing by Ceylon Petroleum Company (CPC) and the Ceylon Electricity Board (CEB). The policy recommendation given by the staff is based on economic principles that ought to increase the efficiency of the companies and adjust accordingly the domestic fuel prices and electricity prices. Although we share the staff's view on the price adjustments, we caution against the political and social implication of such measures. Based on the needed size of adjustment, these measures may have to be taken in several stages, and at an appropriate time. To privatize these corporations in order to increase their efficiencies is welcome, but it must be based on the availability of buyers in the market and must preserve market competition, given these companies hold a monopoly position in the economy.

On structural reforms, although many outstanding structural benchmarks under the program have now been implemented, the overall progress relating to the financial sector and public enterprises needs to be strengthened. These reforms are necessary to attract private sector-led growth of the economy. Legal and institutional reforms can help to attract investors' confidence and improve the balance of payments. However, we need further clarification from the staff regarding the recommendation to reform the labor market as there is not enough information on this issue in the report. As we understand, Sri Lanka's economy is yet to be developed with a high unemployment rate and a significant portion of a non-formal sector. It is therefore quite inappropriate to ask for labor regulation similar to that in advanced countries.

We welcome the completion of all the critical and most of the other recommendations of the safeguard assessment report as well as the country's participation in the FSAP and ROSC. With these remarks, we support the proposed decision, and we wish the authorities every success in facing the challenges.

Mr. Yeritsyan made the following statement:

At the outset, let me agree with the staff proposal to complete the first and second reviews and to grant a waiver for breaching the performance criterion. I also agree with the proposal to extend the current Stand-By Arrangement by another two months.

I welcome the authorities' firm resolve in trying to achieve the program's main objectives. More specifically, the authorities were able to ensure the viability of the newly implemented free-floating exchange rate system and remove the remaining foreign exchange regulations. This has created a good basis for building up a sufficient level of official reserves in the medium term. However, the only reason why distortionary policies, especially in the fiscal sector, did not undermine the credibility of this newly implemented exchange rate regime was because of non-sustainable factors. Some temporary external factors and a shortfall in expected external financing were followed by a significant decline in imports and led to a temporary adjustment in the current account. This does not appear to be a suitable environment for the Sri Lanka's economic outlook, as exports also declined, and GDP growth turned negative for the first time since independence. In this light, full implementation of the program is a minimum requirement to retain sound economic policies and reverse the recent slowdown of economic growth and exports. Now let me turn to a couple of specific points.

First, there is no doubt that the peace process will open new opportunities for sound policies and growth. Nevertheless, the unprecedented decline of output in 2001 calls for a thorough analysis of the factors that caused this decline. We still have to answer the question why the same external and domestic factors did not cause problems of the same magnitude in the past. In this context, I also would like to suggest doing a more quantitative analysis of the risks that are described in the report. Some kind of presentation of alternative macroeconomic scenarios would be the most useful way. I note that growth analysis should become a critical part of the successor PRGF arrangement, as I see that private sector driven growth is the most viable way to go in Sri Lanka.

Secondly, I urge the authorities to strictly follow the fiscal policy objectives and recommendations of the program. The decline in taxes and extensive domestic borrowing, including by the state-owned corporations, are the most critical problems at this stage. I welcome the staff's recommendation to have performance criteria on domestic borrowing by the government. If fiscal slippages continue, I would also recommend changing indicative fiscal targets into quantitative performance criteria at the time of the PRGF arrangement. Following the staff's description of foreign financed versus domestic financed capital expenditures in paragraph 28 of the staff report, I would also recommend to set a target on the basic balance of the budget as, for instance, we have done with other cases. This would result in a further tightening of the fiscal stance, which in my view is critical.

Third, consistent implementation of current agenda of structural reform is vital to put the economy on a sound footing. In this respect, reforms in the financial sector and improving governance in state enterprises are important. These reforms and facilitating the privatization process are key to stimulate the private sector and foreign direct investment. I hope to see more banking sector reform measures derived from the recent FSAP report. In the context of restructuring public enterprises, I would like to note that, as the experience of other countries have demonstrated, tariff increases alone do not lead to a better financial situation in public utility companies if the latter is not accompanied by improved management capacity, overall transparency and reporting. Therefore, I would welcome a box in the next report that updates the authorities strategy in this direction and the advice of international organizations.

Finally, although debt service indicators are still favorable, the authorities should pay serious attention to accelerating government debt, which already exceeded the 100 percent threshold in 2001. The staff's medium-term scenario demonstrates that improved policies and resumption in growth will halt this trend. However, the authorities should persistently refrain from any expensive borrowing. The public corporations should also be discouraged to do so. In this context I fully share the staff's view on discouraging domestic borrowing of the government in foreign exchange and suggesting to extend the limit on overall issuance of treasury bills to other public debt instruments and to set a target on overall debt issuance.

In conclusion, I look forward to see this program fully implemented and all policy distortions mentioned eliminated. I hope that final peace will be achieved soon, thus creating a sound basis for a longer-term PRGF arrangement. I encourage the authorities to work closely with the staff to come up with a strong and reasonably ambitious program before the end of this year.

Mr. Alosaimi made the following statement:

It is unfortunate that last year Sri Lanka experienced the first economic contraction in over half a century. This was mostly beyond the authorities' control as the economy had to face not only an adverse external environment because of the global downturn but also difficulties resulting from natural disasters as well as domestic security conditions. Against that background, I commend the authorities' renewed resolve to the program goals with adherence to all but one of the performance criteria. Given also the policy reassurances as stressed in Mr. Jayatissa's helpful preliminary statement, I support the proposed decision to complete the first and second reviews with grant of the requested waiver and extension.

The policy challenges ahead for Sri Lanka are indeed daunting, especially as the signs of an early end to last year's adverse external and domestic conditions are still tentative. In that regard, the program strikes a reasonable balance for an ambitious but achievable goal. The envisaged fiscal adjustment, while larger than the target set for last year, will still leave the deficit at a high level. As staff spells out in Box 2, the budget envisages a wide range of measures for tax rationalization. The proposals on the spending side are equally well considered with cuts in nonpriority allocations and budgetary savings through debt restructuring. The challenge now is to implement the proposals fully without a recurrence of the slippages that have occurred in the past, given the inherent uncertainties of the projected external financing and privatization proceeds.

On monetary policy, continued tightness supportive of the fiscal agenda is crucial. While I agree on the need for a strong signal from positive real rates of interest at this stage, it is important to also be sensitive to the limits of this policy for the economy's growth goals. This underscores the importance of monetary easing in line with progress on the fiscal front.

On structural reforms, I support the focused approach that the staff suggests for early progress on the critical areas, especially financial sector reforms and public enterprise restructuring. Here, timely implementation of the FSAP mission's recommendations is a priority. Mr. Jayatissa has also outlined the other structural policies, including the intent to accelerate privatization and labor market reforms. Here, I look forward to a further detailing of the policies in the authorities' forthcoming PRSP.

Regarding the authorities' intent to move on to a PRGF arrangement, the immediate priority clearly is to proceed with the timely implementation of the extended SBA. I hope this will facilitate early passage to an arrangement under the PRGF.

With these remarks, I wish the authorities success.

Mr. Wang made the following statement:

First of all, I would like to thank the staff and their well written report and Mr. Jayatissa for his detailed preliminary. Indeed, Sri Lanka experienced a very difficult year in 2001 as GDP contracted 1.25 percent, which was caused by shocks from various sources—an external economic slowdown, internal military conflict, natural disasters, and political crisis. No country can be expected to achieve major economic progress in such an adverse environment.

In spite of the contraction in GDP, however, the important economic indicators have shown that macroeconomic stability has been maintained. The policy initiatives adopted by the newly elected government signal a hopeful trend for a gradual improvement. The overall deficit in the balance of payments has been reversed into a surplus. Gross official reserves picked up from its bottom level in 2000. The terms of trade have shown signs of improvement. The stock market rebounded. Inflation has been contained, despite a record fiscal deficit. The floating exchange rate regime has served the country well in keeping its external competitiveness from deteriorating by maintaining a relatively stable real exchange rate. Even the most significant problem of fiscal imbalance has had a positive side effect, acting as an automatic stabilizer to offset the contraction of the banking system's lending to the private sector. We have noticed that the newly elected government has demonstrated its commitment to the fiscal consolidation and initiated structural reforms to enhance growth in the medium term. Generally, we agree with the staff's observation that the outstanding structural benchmarks in the original program have been implemented as a prior action for the completion of the first and second reviews. We support granting the waiver of the performance criterion for end-December 2001 on net credit to the government from the banking system, completion of the first and second reviews under the Stand-By Arrangement, and the proposed two months extension.

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

Mr. Fenton made the following statement:

We appreciate the challenges faced by Sri Lanka in 2001, and welcome the improved prospects for peace and the new authorities' commitment to the reform process. Accordingly, we support the proposed decisions. This being said, we share the concerns that have been expressed by previous speakers. There are many risks, both external and internal, that threaten the viability of this program. It will require full implementation of the program to succeed.

The staff report is comprehensive and balanced, so I will focus on one point for emphasis—the importance that we attach to reform of the Samurdhi welfare scheme. We are looking forward to the passage of the welfare bill that is intended to be submitted to the legislature in May. The bill should ensure that transfer payments will be properly means tested and focussed on the poorest groups in society. In other words, Samurdhi should function as a true social safety net. At present, far too many people appear to be eligible for these benefits—up to half of the population—yet, according to World Bank estimates, almost 40 percent of households in the lowest expenditure quintile are missed.

With these comments, we wish the Sri Lankan authorities success with their program.

Mr. Prader made the following statement:

The slowing of Sri Lanka's economy due to the global recession and other external factors made 2001 the first year of negative growth since gaining independence in 1947. GDP decreased by 1.3 percent and the budget deficit was substantially above its target, due to the exogenous factors but largely also as a result of the authorities' irresponsible pre-election policies.

Like Mr. Ralyea, I would have preferred to see a new program rather than the continuation of the old one.

Despite the program's derailment in the second half of 2001, all performance criteria were met except the fiscal target on net credit to the government. In addition, all prior actions have been carried out.

To prevent further fiscal slippages, the new government should take advantage of the recent ceasefire to address the major economic challenges vigorously, especially fiscal consolidation and structural reforms.

One major problem is the design of the program. While the 2002 budget target of 8.5 percent will require the implementation of significant adjustment measures, the target itself is not ambitious, is subject to large risks, continues the tradition of high fiscal deficits, and will add to the already high level of public debt.

In its present form, I think the design of the program is best suited to a holding operation. I think a Fund program which envisages deficits of that magnitude is not really a stability-oriented program. With it, the best we can do is to prevent the worst. We will not accomplish any significant adjustment, and the already very high debt burden will just get bigger. We live with a debt increase 8, 9, or 10 percent a year. This is unacceptable. I think the next successor arrangement should address the problem of the debt overhang, and we must insist on deficit targets which are consistent with sound fiscal policies. What we have now, let me say again, is a case of minimal adjustment, a holding operation only, and will not get the country ahead.

We hope and expect that future Fund arrangements will be more ambitious and will break with this tradition by bringing about an appropriate level of fiscal discipline. We would be interested in the staff's response to some of the ideas suggested by Mr. Ralyea for the successor arrangement.

We welcome the major overhaul of the tax system announced in the 2002 budget, especially the elimination of the National Security Levy, adoption of a dual-rate VAT with a much broader base, rationalization of tax incentives, and a general streamlining of the tax regime to make it more transparent. We object only to the new tax holidays for target sectors, which undermine the above-mentioned reforms and should be eliminated.

On the expenditure side, savings could be realized by reducing transfers to state corporations and better targeting welfare. If the ceasefire holds, it will be possible to redirect some defense spending to social ends. Tight control over the public finances would help reduce the fiscal deficit and release funds for public investment.

The report mentions that the budget deficit is to be financed by greater reliance on external aid flows and asset sales. What does the staff suggest if these flows do not materialize? This is particularly worrisome given the authorities' past record and the inability to identify adequate contingency measures on their own.

The economy needs further liberalization in the form of deregulating state-dominated activities, and opening them to private-sector investment and competition. In this connection we commend the authorities for freeing administered prices, and their intention to renegotiate some of the agreements conferring monopoly status on privatized companies.

We also welcome the authorities' plan to liberalize the petroleum sector by the end of this year, and we urge them let private companies freely import and distribute petroleum products. Because the Ceylon Petroleum Corporation (CPC) is still overstaffed and badly managed, its imminent restructuring should split up its importing, distributing, refining, and transporting functions and allowing each of them to function as an independent commercial entity in competition with the private sector.

The reorganization of the Ceylon Electricity Board (CEB) into three autonomous bodies separately handling generation, transmission, and distribution should be put on the fast track.

In the financial sector, we applaud the authorities' plans to complete the restructuring of the two state banks, and we urge them to take full advantage of available technical assistance. There is also a need to restructure the remaining state insurance corporation, and for further measures to stimulate the capital markets.

Because the civil service and pension reforms are politically sensitive, the authorities must proceed cautiously. The first step in civil service reform will be to make sure that the cap on the numbers of government employees is strictly observed.

Finally, the signs of a national peace are still tentative. I hope that the "elusive dream of the national peace" Mr. Guinigundo mentions will come true soon.

With these remarks, we support the proposed decisions.

The staff representative from the Asia and Pacific Department (Mr. Carter), in response to Messrs. Ralyea and Prader, remarked that the staff had not recommended discontinuing the program and starting over with a new SBA because the staff wanted to focus on moving Sri Lanka to a PRGF arrangement and a structurally sound medium-term program. In continuing with the current SBA, the staff hoped to reverse the disasters of 2001, begin fiscal consolidation, and continue the structural reform program. A quick move to a PRGF arrangement was based on two tenets: the importance of implementing those structural reforms identified many years before, and a completely tight fiscal position. Reducing the fiscal deficit from 10.8 percent of GDP to 8.5 percent of GDP would not be inadequate, although it would be true to view it as a first step. There was significant room for tackling overspending in the current expenditure budget for 2003. The size of the public service was the primary source of overspending, which was a key element of structural reform. Reducing the size of the public service was also key to solving the debt problem in providing a larger safety margin for budgets in the future.

On the issue of why labor market reform was so important in Sri Lanka, current labor market rigidities made it almost impossible to efficiently change resources for private sector companies, the staff representative continued. At the same time, market rigidities made it expensive and risky to rationalize the public sector. That was why the staff support the prime minister's initiative to make sure that labor market issues would be dealt with on a speedy basis. The authorities would not be adopting state-of-the-art advanced country labor laws and regimes, but at least they would embark on a process whereby companies could make changes, which could lead to an atmosphere conducive to a reduction in the public sector. Labor market reform also was commensurate with reform of the social safety net. Sri Lanka did have a relatively generous social safety net, but it was not working properly because it was not well-targeted, and would have to be reformed to protect the unemployed once reform of the public sector was embarked upon.

Mr. Jayatissa made the following concluding statement:

> There is a clear recognition that Sri Lanka has been undergoing serious economic difficulties due to various factors. Many constructive comments were made by the Directors in their statements and interventions today. I will convey all these to my authorities faithfully. I am glad there has been a discussion of the difficult problems in Sri Lanka and a genuine appreciation of the commitments made by the new government to face up to these challenges, particularly to improve macroeconomic stability and implement structural reforms towards sustainable high growth in the medium term, while taking clear, positive steps to move forward with the peace process.
>
> On fiscal policy, almost all Directors said the importance of adhering to fiscal targets laid down in the budget and further fiscal consolidation in the medium term, particularly in view of the high debt levels. While I welcome the policies announced in the budget, it was highlighted that fiscal consolidation needs both revenue enhancing measures and expenditure restraint. At this stage I would also like to mention that in the budget preparation process, my authorities received the most valuable inputs from the Fund staff. There were frank and open discussions between my authorities at the highest level and the Fund staff, and these inputs have been very productive. My authorities clearly benefited from the discussion, and I thank

the staff and the management for the advice given to my authorities. They highlight the need for work to avoid further fiscal slippages.

On public corporation reforms, short-term measures have been implemented, but in addition to these, the authorities are clearly committed to the structural reforms, particularly the reform of the CEB and CPC. These will be further articulated in the forthcoming policy discussions with the World Bank and AsDB and other donors.

With regard to social spending, there is a need to target and rationalize social expenditure. The new Prime Minister believes that there should be a welfare benefit law to provide a sound and firm basis for welfare programs so that these will be implemented in the most transparent manner, and progress has been made in this regard.

On the monetary and exchange rate policy, many Directors agreed that monetary policy has been appropriate, while highlighting the importance of maintaining a reasonably tight policy until fiscal consolidation is firmly established. They have also noted that the exchange rate policy has served well and indicated that there should be further improvement in the functioning of the foreign exchange market.

On banking sector reforms, as the staff has mentioned, our authorities are moving forward with further reforms. They will be seeking Fund/Bank technical assistance to articulate these reform efforts. On the structural front, Sri Lanka is making a lot of progress. Given the need to implement measures in a large number of areas, there is a need to prioritize the programs. In addition to financial sector reform, labor market reform, privitazation, and corporate sector reform, the import of public sector reforms have been highlighted today, and I will convey this to my authorities faithfully. On a future PRGF arrangement, there is broad support to embark upon a PRGF-supported program

In conclusion, Mr. Chairman, I thank once again for the dedicated and hard work of the staff team headed by Mr. Carter. My authorities have always welcomed the Fund's policy advice, and I must also thank the World Bank, AsDB, and other bilateral donor communities who are playing a useful role in extending support for Sri Lanka. Similarly, the Fund's resident representative in Colombo, Mr. Haque, has been useful in enhancing the policy dialogue, and also to help strengthen the reform program. The program has also benefited by Mr. Anoop Singh's visit to Colombo, and I thank all my colleagues in the Board for their views and constructive comments made today. On behalf of my authorities and, last, me personally to you, Mr. Chairman, I thank you for helping Sri Lanka move forward in their reform efforts.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the new government for reviving the program soon after assuming office. They noted that the Fund-supported program had achieved its immediate goal of halting the drop in official reserves. Nevertheless, overall macroeconomic performance under the program had been mixed, with broadly satisfactory inflation occurring in the context of a sharp drop in output. The output decline was principally linked to external shocks and drought. However, an additional factor was the erosion of confidence resulting from political instability in the second half of the year that led to fiscal policy reversal and a cessation of structural reform.

Against this background, Directors noted that the new government needs to re-establish conditions for fiscal sustainability, lasting growth, and poverty reduction. They supported the 2002 budget, which aims to rein in the fiscal deficit and losses incurred by the state enterprises. They also welcomed the progress that has been made on the peace front, which should significantly improve both business confidence and the willingness of the donor community to support the authorities' reform efforts.

Directors endorsed the authorities' fiscal plan to reduce the overall budget deficit by more than 2 percent of GDP through tax reform and a tight control on spending. On the revenue side, Directors welcomed the steps that were being taken to rationalize the Goods and Services Tax and National Security Levy into one value added tax, simplify the income tax and import duty regime, and shift away from the temporary surcharges that were imposed in 2001. Directors stressed the importance of implementing the budget measures quickly and in full, with close monitoring to ensure that the fiscal program remained on track.

Directors welcomed the authorities' intentions to privatize the state-owned telecommunications and insurance companies by end-2002. They noted the important contribution of privatization receipts to financing the budget. In addition, restructuring and privatization of other state sector companies, especially the petroleum and electricity companies, would be an important goal. In light of the preparatory work that remains to be done on many of these companies, most Directors emphasized the need to move forward quickly. A few other Directors cautioned that privatization should be well prepared and handled with care, and sequenced in the context of growing business confidence and propitious market conditions.

Directors noted that the experience with the rupee float has been broadly favorable, and they urged the authorities to improve the operations of the foreign exchange market in the context of the current exchange rate regime. The central bank had maintained a generally prudent monetary policy stance during 2001, and Directors considered that monetary policy should remain fairly tight until inflation has clearly come down and fiscal consolidation is credibly advanced.

Directors welcomed the government's structural reform agenda as the first steps toward tackling the crucial impediments to sustained private sector-led growth. They noted that early implementation of these measures, especially those focused on the operations of the loss-making state sector, will also be critical for macroeconomic stability. In this context, Directors supported the measures taken to improve the financial position of the electricity and fuel companies through price adjustments, accompanied by actions to restructure these enterprises. They welcomed the further efforts being made to strengthen the financial sector and the actions to improve the labor market.

Directors noted that the external financing needs for the coming year remain large. In this vein, they urged the authorities to implement the planned measures on land, labor market and enterprise reform to ensure timely disbursements from the World Bank and Asian Development Bank.

Directors welcomed the considerable progress made in implementing the Safeguards Assessment recommendations. The critical and high priority measures have already been taken and the central bank has started to act on the remaining recommendations.

Directors agreed that successful completion of the SBA would be a useful bridge to a longer-term program that could be supported by a PRGF and urged the authorities to move toward such an arrangement as soon as possible. In this respect, they urged the authorities to move quickly to finalize a focused and credible poverty reduction strategy.

Directors welcomed the authorities' consent to the publication of the staff report and program documents.

The Executive Board took the following decision:

1. Sri Lanka has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Sri Lanka (EBS/01/41, Sup. 1, 4/24/01) ("the Arrangement") to review program implementation.

2. The letter from the Minister of Finance of Sri Lanka and the Governor of the Central Bank of Sri Lanka dated April 1, 2002, together with its attached Supplementary Memorandum of Economic and Financial Policies ("the March 2002 MEFP") and Technical Memorandum of Understanding, shall be attached to the Arrangement, and the letter from the Minister of

Finance of Sri Lanka and the Governor of the Central Bank of Sri Lanka dated March 19, 2001 shall be read as supplemented and modified by the letter dated April 1, 2002.

3. Accordingly:

a. the period of the Arrangement shall be extended through August 19, 2002 and paragraph 1 of the Arrangement shall be amended by substituting the words “16 months” for “14 months”;

b. paragraph 2(a) of the Arrangement shall be amended to read as follows:

“Purchases under this Stand-By Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 103.35 million until August 30, 2001 and the equivalent of SDR 151.68 million until June 30, 2002.”;

c. paragraph 3(a)(i) of the Arrangement shall be amended to read as follows:
“the ceiling on change in net domestic financing of central government deficit, or”;

d. the quantitative performance criteria referred to in paragraph 3(a) of the Arrangement shall, for end-April 2002, be as specified in Table 1 of the April 2002 MEFP; and

e. paragraph 3(c) of the Arrangement shall be amended to read as follows:

“after August 29, 2001, November 29, 2001 and June 29, 2002, until the respective reviews contemplated in paragraph 23 of the Memorandum and paragraph 30 of the Supplementary Memorandum of Economic and Financial Policies attached to the letter from the Minister of Finance of Sri Lanka and the Governor of the Central Bank of Sri Lanka dated April 1, 2002 are completed; or”.

4. The Fund decides that the first and second reviews contemplated in paragraph 3(c) of the Arrangement are completed and that Sri Lanka may make purchases under the Arrangement:

a. on the condition that the information provided by Sri Lanka on the implementation of the measures specified in Section I of Table 2 of the April 2002 MEFP is accurate; and

b. notwithstanding the nonobservance of the end-December 2001 performance criterion on the ceiling on banks' net claims on government previously specified in paragraph 3(a)(i) of the Arrangement. (EBS/02/59, 4/1/02)

Decision No. 12722-(02/41), adopted
April 15, 2002

3. TURKEY—2002 ARTICLE IV CONSULTATION; AND REVIEW UNDER STAND-BY ARRANGEMENT

Documents: Staff Report for the 2002 Article IV Consultation and First Review Under the Stand-By Arrangement (EBS/02/61, 4/4/02; Cor. 1, 4/11/02; Cor. 2, 4/12/02; and Sup. 1, 4/4/02); and Statistical Appendix (SM/02/106, 4/8/02)
Staff: Kahkonen, EU1; Ebrill, PDR; Marston, MAE
Length: 2 hours, 35 minutes

The staff representative from the European I Department (Mr. Kähkönen) submitted the following statement:

This statement provides an update on economic and policy developments since the staff report (EBS/02/61, 4/4/02) was issued. The new information does not change the thrust of the staff appraisal.

The authorities have now met in substance all the outstanding structural conditions relevant for the first review:

They have fully met the prior action regarding the Law on Public Debt Management. The Law was passed by parliament on March 28 and signed by the President on April 8. Two supporting communiqués—one on government debt guarantees and the other on nonguaranteed foreign borrowing by state entities outside the central government—were issued on April 12. While this was within five days of the scheduled Board meeting, the World Bank and Fund staffs did review the regulations, and found them to be to their satisfaction.

Satisfactory progress has been made toward completing the prior action regarding the identification of redundancies in state economic enterprises (SEEs). As noted in the staff report, all open, unfilled, redundant positions in SEEs have been eliminated. Based on an aggregate study the authorities have tentatively identified the number of remaining redundant workers in SEEs as 40,000-60,000. However, these estimates need further refinement. The authorities have committed themselves to producing final estimates by end-May, using company-specific information. Moreover, the authorities have reaffirmed their commitment to reduce the number of redundant workers by one third by end-June and two thirds by end-October

2002, and completely by end-June 2003. On this basis, the staff views progress in meeting this prior action as satisfactory.

All six structural benchmarks relevant for the first review have been met. Three of them had been observed by the time the staff report was issued. The three remaining benchmarks have since been met, as follows. On April 10, the BRSA appointed the third-party auditing firms that are needed as part of the banking restructuring plan. On April 8, the government appointed the board of the independent procurement agency. And by April 12 all SEEs had in place budgets in line with mandated cost reductions.

Market sentiment has remained quite positive, and interest rates have been reduced further on the heels of another low inflation outcome in March. Between end-March and April 12, the Turkish lira appreciated by a further 4 percent relative to the U.S. dollar (to a shade below TL 1.3 million to the U.S. dollar), the interest rate on the benchmark treasury bill (maturing in February 2003) declined by 5 points to 57 percent, and stock prices increased by 6 percent. The favorable March inflation outcome (monthly CPI increase of 1.2 percent) helped to reduce inflation expectations further (by about 4 points, to 39 percent for end-2002 in the survey conducted by the CBT in early April) and prompted the CBT to reduce its overnight rate by 300 basis points on April 8, to 66 percent.

The staff supports the authorities' request to waive the applicability of the end-March performance criterion on the cumulative primary balance of the consolidated government sector. The relevant full information is not yet available. Partial data for the central government suggest that the performance criterion is likely to have been met.

Mr. Kiekens and Mr. Çakir submitted the following statement:

Overview

Turkey is implementing two major programs with encouraging results: the Fund-supported program of stabilization and reform, and a strategy for accession to the European Union. Both are ambitious, and both are critical for Turkey's future. They also complement one another. The Fund-supported program aims at financial stability, low inflation, a strong financial sector, sound public finances, and an economy resistant to shocks. Far-reaching structural reforms will make financial stability durable. Equally important, it will raise Turkey's growth potential. All of these objectives are essential for accession to the European Union. At the same time, Turkey's credible prospect of joining the Union in the not distant future will greatly reinforce its economic and political stability, and help narrow the incomes gap between Turkey and the present EU members.

During the last decade, Turkey made insufficient progress toward catching up with the European Union, for reasons which are now well understood. The slow growth of Turkey's capital intensity was a major constraint. Indeed, high inflation and financial instability have limited the development of credit markets and prevented sufficient mobilization of domestic savings and efficient financing of investments. Domestic credit as a percentage of GDP is about 30 percent, substantially below that of comparable countries, where inflation is substantially lower than in Turkey. The resulting low levels of business and infrastructure investment have slowed the growth of both productivity and employment. Moreover, it is now clear that better education and increased technology transfer from abroad can reverse the last decade's slowing of total factor productivity growth.

There are good reasons why Turkey can speed its real convergence with the European Union. In the last couple of years, it has laid the necessary groundwork. The structural causes of the growing deficits in the primary fiscal accounts have largely been eliminated. Monetary and financial stability is within reach, and the structural reformation of the real economy is advancing.

The too generous social security system has been reformed.

The reformation of agricultural policy is perhaps the most far reaching phase of the program, touching the lives of 40 percent of the population. The distortive price subsidies of the past have been eliminated. However, increased agricultural productivity will take time to achieve. Several millions of farmers will need to find work elsewhere, or at least their children will no longer work at farming. From the social and political viewpoint, this transition is crucial. To support it, a well-targeted incomes support scheme costing about $2 billion annually has been put in place. Faster growth of the industrial and services sectors in the affected areas will also be essential, as will the improvements in education.

The restructuring of the State Economic Enterprises and their eventual privatization is another main component of the strategy to put the public finances on a sound footing. Good progress has already been made. In those enterprises, as in the agriculture sector, shedding many redundant workers is just as necessary for the long-term welfare of all Turkish people as it is immediately difficult for those affected.

The banking sector has long been weak and vulnerable to financial shocks. It was particularly hard hit by the exchange rate crisis, which in its turn may have resulted partly from financial sector weaknesses. The financial reformation of the state banks has been executed in a very satisfactory manner. The Banking Regulation and Supervision Agency is working hard to enable Turkey to meet the relevant international standards by the end of this year.

In order to increase total factor productivity and stimulate growth, Turkey needs to attract foreign savings, particularly in the form of FDI, to complement private domestic savings in financing the investments needed to effect rapid convergence with the EU. In the past, Turkey's economy has attracted too little foreign direct investment, although for many successful emerging economies it has been a major source of growth, employment, and stable foreign financing.

The implementation of the economic reform and the adoption of specific policies aimed at attracting foreign investments will enable Turkey to perform much better in future years and maximize the benefits of its customs union with the EU. Continued good progress toward accession to the EU will give a strong additional boost to the Turkish economy.

Recent Macroeconomic Performance

In 2001 real GNP fell by 9.4 percent, almost 1 percent worse than anticipated by the program, making this Turkey's worst recession since 1945. This year a modest recovery still seems possible, supported by a gradual recovery of domestic demand. Inventories are now depleted, so that a boost from stock building can also be expected. These factors, combined with continued progress in bank and corporate restructuring, declining inflation and interest rates, and a steadier exchange rate, could produce a growth rate as high as 3 percent in 2002.

Following February's favorable inflation outcome, the inflation figures for March were 1.2 percent for CPI and 1.9 percent for WPI—much lower than the markets expected. The year-end target of 35 percent for CPI inflation now seems more realistic in the view of market participants. The Central Bank of Turkey (CBT) surveys of inflationary expectations suggest that those expectations are declining. According to the CBT's recent survey, the expected level of CPI inflation for the next 12 months was 39.1 percent, as opposed to 50.1 percent at the end of December 2001.

The nominal exchange rate continued to appreciate in March and early April, bringing the total appreciation since October 2001 to around 22 percent. In the coming months exports may be slow, due to real appreciation of the Turkish lira and the global slowdown. The projections for the current and capital accounts are broadly unchanged. It is expected that the exchange rate appreciation and higher oil prices will offset the better than projected outcome for 2001. The projection for Eurobond issues was increased by $0.5 billion and the projected decline of interbank credit lines was lowered by $1 billion, to reflect the improvement in the outlook. In consequence, gross reserves could increase by almost $1.5 billion over former projections.

Fiscal Policy

With great determination, the government has maintained the very tight fiscal stance needed to reverse a dangerous trend in the behavior of the public debt.

Despite the steep reduction of GNP in 2001, considerations of sustainability required the authorities to follow a contractionary fiscal policy, with the result that the primary surplus for the consolidated government sector was 5.9 percent of GNP, almost 0.5 percent higher than the program projections. In 2002, the authorities are confident that a public sector primary surplus of 6.5 percent of GNP is within reach. If the present primary surplus of 6.5 percent of GDP can be maintained for the next four years, and growth becomes 5 percent annually from next year on, the IMF's debt sustainability analysis shows steadily declining debt-to-GDP ratios, reaching 64 percent in 2006, almost 30 percentage points lower than at the end of last year.

Legislation to simplify indirect taxation has been submitted to the Council of Ministers. Tax administration will be reformed in depth this year. An audit coordination unit will be established in the Ministry of Finance (MoF) and will produce an audit plan for the next year. MoF will devise a strategy for strengthening the collection of public sector tax arrears; the number of auditors will be increased; and the revenue administration will undergo a functional reorganization. An independent procurement agency is being established as part of reinforcement of expenditure management, and its board will shortly be appointed.

Debt Management and Recent Market Developments

Parliament recently enacted, and the president approved, the Law on Public Debt Management. This law and its supporting regulations call for organizational changes within the Treasury to improve risk assessment and achieve better coordination in the management of domestic and external debt. The law also provides a framework for the Treasury's issuance of guarantees.

Improved confidence and the easing of short-term concerns about the rollover of the public debt have enabled the Treasury to substantially lengthen the maturities of domestic borrowings. On April 9, the Treasury issued $1.2 billion worth of one-year T-bills, bearing an annually compounded yield of 58 percent. This auction attracted substantial demand: the bid-cover ratio was 2.4. The Treasury's two-year FRN issues have reached $3.3 billion since the beginning of this year. The Treasury also has good access to the international financial markets. So far this year, the Treasury's Eurobond issues have reached almost $1.5 billion, with favorable yields and maturities up to 10 years. Eurobond spreads are decreasing in both the primary and secondary markets.

The Treasury recently intensified its communications with markets by establishing an investor relations office in February. This office is expected to become more active. An interactive web site will be opened this month. The Treasury continues to hold its regular monthly meetings with commercial banks to discuss recent market developments and its own borrowing policies. To promote Turkey as an investment destination and keep up with international viewpoints, an Investor Council composed of high level officials of major international corporations will be launched in July 2002.

Monetary and Exchange Rate Policy

The central bank will continue to concentrate on keeping inflation within the targeted limit of 35 percent for 2002. The low monthly inflation figures for February and March have caused a significant drop in inflationary expectations, making it possible to further cut interest rates. On April 8, the CBT reduced the interest rates by another 300 basis points on a simple basis annually. This brings the cumulative reduction in interest rates to 800 basis points since the beginning of the year. The annually compounded overnight interest rates are now 66 percent. The CBT still intends to launch inflation targeting in 2002, although it is thought to be too soon to announce a starting date. Further progress toward meeting the preconditions for successful inflation targeting, and a longer track record of inflation reduction, will be sought to make the formal introduction of inflation targeting more credible.

The CBT intends to use the improved balance of payments and the reversal of currency substitution to build up its foreign exchange reserves. Although the ratio of short-term debt to reserves has improved since September 2001, further increases in the reserves of the CBT are still needed. From the medium-term standpoint, reserve accumulation will strengthen market confidence and make Turkey more resistant to external shocks. In late March the CBT announced the start of daily auctions to purchase foreign exchange, and bought $140 million worth in the first 10 days of April, with auction quotas of $20 million per day.

The CBT also accumulates reserves passively, by offsetting the liquidity effects of the Treasury's foreign exchange borrowings (the proceeds of which are exchanged into Turkish liras) by means of money market operations instead of last year's foreign exchange sales. The Treasury will also continue to lengthen the maturity of its borrowings, and will borrow in excess of redemptions as far as market conditions allow in order to reinforce the sterilization policy of the central bank.

Banking Sector Reforms

A legal scheme allowing public money to be used under strict conditions to assist the recapitalization of banks was put in place in February

2002. Since then, the Banking Regulation and Supervision Agency (BRSA) has issued regulations and guidelines. The first stage of the process, involving a targeted valuation of bank portfolios as a basis for reliable estimates of a banks' net worth will be completed shortly. The second stage is performing additional reviews to verify that regulations and guidelines have been complied with while estimating a bank's capital needs. BRSA appointed the auditing firms for the second stage. But despite all this progress, it seems likely that there will be a slight delay in calling shareholder meetings and raising the capital to qualify for public support.

Operational restructuring of the state banks in preparation for privatizing them is also moving ahead. The Ziraat and Halk Bank continued closing their redundant branches. Five potential bidders have expressed interest in the privatization of Vakif Bank, and are conducting due diligence reviews. The SDIF is taking further steps to resolve the four intervened banks it still owns, as detailed in the paragraph 12 of the Letter of Intend. To ensure transparency, an auditing firm has been appointed to carry out the annual audit of SDIF.

Corporate Sector Restructuring

The authorities are taking steps to promote corporate debt restructuring as a complement to their rehabilitations of banks. The voluntary market-based framework for restructuring corporate debt—the so-called "Istanbul Approach"—was launched in January 2002. A framework agreement to be jointly signed by creditors, which would be used as the basis for debt workouts, has been finalized but is not yet signed. The World Bank is presently finalizing a corporate assessment procedure which will improve the strategy for corporate sector restructuring (the "Istanbul approach"). To carry out restructurings of medium-size loans, a private asset management company will be set up in August 2002 in which the SDIF will own a minority share. The authorities are also committed to reform the bankruptcy law and execution procedures to conform to the recommendations of an insolvency ROSC prepared by the World Bank.

Other Structural Reforms

The authorities, assisted by the World Bank, completed a macro-level study on state economic enterprises that suggested overstaffing by some 40,000-60,000 employees (out of a total number of 420,000. By the end of May the authorities will convert these estimates into company- and position-specific targets, and reduce the identified redundancies by one-third by the end of June, and by two-thirds by the end of October. Given the low economic activity and the high unemployment rate, the authorities wish to avoid as many layoffs as possible, relying instead on voluntary retirement of workers.

With a view to improving transparency and governance, the Council of Ministers issued a decree spelling out an action plan for this purpose. The plan is part of a broader effort to reform the public sector, which also includes public expenditure management and civil service reform. During April, a ministerial steering committee and a sub-committee to oversee the implementation of this plan will be formed. Legislation to reduce the paperwork required to collect investment incentives is being prepared, and a new law on Foreign Direct Investment is being prepared.

The authorities welcome the findings of Turkey's safeguards assessment, and will act on the recommendations and the established plan for further improving the transparency and effectiveness of the central bank's control, accounting, reporting, and auditing systems.

Waiver of Applicability

Data for the performance criterion on the cumulative primary balance of the government sector, whose test date is March 31, 2002, are not available for the present meeting. Our authorities request a waiver of applicability.

Mr. Mirakhor submitted the following statement:

We agree with Mr. Kiekens and Mr. Çakir that Turkey has made encouraging progress under the stand-by arrangement. Despite the worst recession in Turkish history, the authorities have managed to keep macroeconomic policies on a tight leash, inflation has started to decline, external situation has improved, and good progress was made in meeting the program's structural conditionality. Notwithstanding these impressive accomplishments, near-term risks and fragilities remain underscoring the importance of keeping policies firmly oriented towards solidifying the foundations for lasting stability and an early return to high-quality growth.

As staff note, the central plank of the new program is fiscal sustainability—an area in which the authorities have performed admirably. This impressive performance is set to continue in 2002, and we join staff in commending the authorities for their "unwavering commitment" to a bold target for the public sector primary surplus. While budget implementation is not without downside risks, arising mainly from higher-than-expected petroleum prices, the authorities' commitment to take offsetting measures, whenever needed, is reassuring. Fiscal sustainability will, however, require underpinning budget targets with meaningful structural fiscal reforms. In this regard, we attach particular importance to the twin pillars of improved expenditure management and transparency, and strengthened revenue administration. A key challenge on the expenditure side will be the authorities' ability to address the delicate issue of overstaffing in state economic enterprises. We support the authorities' strategy of using voluntary early retirement to reduce identified redundancies, but agree that it may be difficult to achieve targets without resorting to layoffs. We presume that the World Bank's Privatization Social Support Project and unemployment insurance payments will help mitigate the hardship that layoffs will entail.

The CBT has demonstrated skill and adeptness in managing the floating exchange rate and has strengthened the foundations for successful disinflation. The recent data on inflation are encouraging and appear to have affected expectations favorably. Nevertheless, meeting the year-end inflation target will still be a challenging task and will be seen as a test of the success of the program. While many of the preconditions to a formal inflation targeting regime appear to be in place, we agree that an announcement of a start date, at this juncture, is premature and that more time should be given to build up a track record on disinflation. This would render the eventual move to inflation targeting more credible. We support CBT's strategy of using the better-than-expected external position to build up foreign exchange reserves as a means of bolstering confidence and providing a cushion against contingent risk. It will, nevertheless, be important to keep base money within the targeted path through sterilization, using longer-term CBT instruments. We encourage the authorities to remove distortions that preclude the deepening of money and foreign exchange markets.

The recent rapid rebound in the Turkish lira has sparked some concern about external competitiveness, and we are pleased that staff have addressed this issue (Box 3). Given the divergence in cost and price-based indicators, it appears that the evidence is not clear-cut and that the situation deserves to be monitored carefully. In any event, we agree with the view that a lasting boost to competitiveness could be only achieved if exchange rate movements are underpinned by structural improvements that durably raise productive efficiency. This highlights the importance of continued structural reforms, including in the area of private sector development.

The authorities are to be commended for introducing some fairly radical reforms in the banking system—a key source of vulnerability in the past. Notable achievements have been made in restructuring state banks, and good progress is being made with operational restructuring of these banks in preparation for privatization. However, as the authorities recognize, the task ahead is both compelling and challenging. The SDIF needs to continue to resolve the issue of intervened banks, still under its ownership, while ensuring full transparency in its operations. Concurrently, banking sector reform needs to be complemented by the early operationalization of the framework of the restructuring of corporate debt (the Istanbul Approach). We are pleased to learn that the privatization process is to be rejuvenated. The improved market conditions should help the authorities move more aggressively in this area.

In sum, given encouraging program implementation and evidence of some positive initial results, we have no hesitation in agreeing to staff recommendation for the completion of the first review under the SBA. The authorities have now built up a good record of policy implementation, which is being rewarded by a return of confidence. While risks and challenges remain, we concur with staff that the best strategy to mitigating risks is continued diligent and credible policy implementation so as to meet program objectives.

Mr. Wei submitted the following statement:

At the outset, I would like to thank staff for their well-written and comprehensive report and Mr. Kiekens and Mr. Çakir for their insightful preliminary statement.

In the last five months, under the new SBA the Turkish economy has shown an encouraging turnaround having experienced the deepest recession last year in 50 years. Inflation has started to decline, the lira has rebounded from deep depreciation in 2001, and business confidence has begun to surge. Furthermore, all quantitative performance criteria relevant to the first review were met due to the authorities' strong policy efforts. At the same time, in the letter addressed to the Managing Director by the Turkish Minister of State for Economic Affairs and the Governor of the Central Bank of Turkey, we see the authorities' determination to stick to sound macroeconomic policies and press ahead with structural reforms to realize both the 3 percent growth target and the 35 percent inflation target set for 2002. Based on these developments, we support the completion of the first review of the SBA, the proposed decision, and waiver of applicability requested by the authorities on the cumulative primary balance data for the present meeting.

Since I broadly agree with the staff appraisal on Turkey's economic prospects and policies, I would like to comment on monetary and fiscal policies, financial sector reforms, and FDI policy.

Monetary Policy

Harnessing the chronic hyperinflation is the authorities' top priority and the inflation target is the appropriate policy choice right now. We take note of staff's view that the main factors driving the inflation rate up were the nominal exchange rate, domestic demand pressure, wage levels, and basic commodity prices and that the forward-looking price-setters have increasingly outweighed the backward-looking ones. Therefore, it is appropriate that staff and the authorities agree on adopting an inflation target to break the inflation inertia in the context of a floating exchange rate regime. The Central Bank of Turkey has implicitly committed to a 35 percent inflation rate target for end-2002 and prepared to set up a formal inflation target regime in mid-2002.

However, there are some important preconditions for a successful and lasting inflation target regime and it is important to have these elements in place when, or soon after, the authorities adopt this regime. Otherwise, large deviations from the targets will harm the central bank's reputation.

In our view, the first key element is the ability of the central bank to forecast fundamental economic variable trends—potential output, external competitiveness, and equilibrium exchange rate—and set out feasible inflation targets. In this regard, staff's suggestion to improve the central bank's forecast ability is well taken.

Second, scientific base money programming, an efficient interest rate transmission mechanism, and a deepened money market are essential if the central bank is to bring the inflation rate around target. In this area, the authorities' intention to correct distortions on Turkey's money and foreign exchange markets is in the right direction.

Third, it is also very important that foreign reserves are well managed and that the monetary impact of foreign reserve transactions is sterilized. Given that foreign deposits account for nearly half of broad money, establishing appropriate foreign reserves can enhance market confidence. However, it is essential to sterilize the purchase of foreign reserves to avoid inflation pressure in the economy. In this regard, we welcome the authorities' efforts on sterilization policy, such as lengthening sterilization maturities.

Fourth, structural reforms—reducing price setting distortions in the economy, moderating wage increasing pressure in the public sector, and bringing competition into monopolized industries, for example, the electricity and telecom industries—are indispensable in establishing market price setting mechanisms and helping to achieve the inflation target.

Fiscal Policy and Public Debt Management

On fiscal policy, we join staff in commending the authorities' unwavering commitment to a public sector primary surplus target—6.5 percent of GNP for 2002. This lays a sound foundation for the authorities to bear the cost of disinflation and gradually pay back the accumulated high level of public debt. However, we see some potential expenditure pressure arising from restructuring the financial sector. It would be appreciated if staff could estimate how much this cost will be and whether it has been taken into account in this year's budget and those for the next few years.

On public debt management, we welcome Parliament's passage of the Law on Public Debt Management and the increased attention on risk assessment and coordination in managing the domestic and international debt portfolios. Both the reintroduction of floating rate note issues and tapping the Eurobond market at favorable yields and long maturities show released pressure on the public debt service and we see good prospects for the authorities to discharge their Fund obligations in a timely manner.

Financial Sector Reforms

The financial sector was the main source of the 2000 economic crisis and remains a drag on economic growth. As mentioned in Mr. Kiekens' and Mr. Çakir's preliminary statement, domestic credit as a percentage of GDP is about 30 percent. Thus, to quickly restructure state banks and rehabilitate the private banking system is crucial in bringing the malfunctioning financial sector back on track and in bolstering economic recovery. We welcome the recapitalization scheme for private banks under the guidance of the Bank Regulation and Supervision Agency as well as the commitment of the Saving Deposit Insurance Fund to resolve the remaining intervened banks and ensure transparency in this process. The corporate debt-restructuring framework "Istanbul Approach" has important implications for complementing bank rehabilitation.

FDI Policy

From the BOP table we see that over the past several years, under the capital and financial account, the FDI inflow figures averaged US$1 billion a year and were much lower than those in "other investment liabilities" which averaged US$8 billion a year. Since FDI is a quite stable long-term capital inflow and contributes to capital account stability, it is very wise that the authorities have begun to improve their FDI policy and bring about a sound business environment for foreign investors by preparing a new Law on Foreign Direct Investment, enhancing law enforcement and streamlining the complicated investment approval process. Furthermore, we warmly welcome the scheduled inaugural meeting of the top-level Investor Council in July 2002, to which the heads of the Fund and the World Bank and 20 chief executives of European, Japanese and US corporations have been invited.

In conclusion, I would like to wish the authorities great success in meeting the challenges in this critical year when a solid foundation will be laid for future sustainable growth and a healthy inflation path.

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

We thank staff for the set of papers on Turkey, which provide a good account of the country's economic developments during the last years, and Mr. Kiekens and Mr. Çakir for their very informative and comprehensive preliminary statement. We also commend the Turkish authorities for their persistent efforts to address the deep-rooted problems in the economy, such as structural rigidities and weak public finances. Three major attempts to address said problems have taken place in the last two years, the last one in response to the September 11 events. Thus, by the beginning of this year, a new medium-term Fund-supported program was initiated, and the reform agenda of the country continued.

Even though the new program has been in effect for a short period, developments are encouraging, and include a substantial improvement of financial market conditions from their post-September 11 low levels, a waning of short-term concerns about the public debt rollover, and a declining of inflation. Before the approval of the program, the authorities met more than ten prior actions in the fiscal and structural areas, and under the program, all quantitative performance criteria relevant for the first review have been met. Particularly noteworthy is the fact that the public sector primary surplus target of 5.5 percent of GNP for 2001 was exceeded by almost 0.5 percent of GNP. The authorities also deserve recognition for the progress being made concerning the program's structural conditionality. All the outstanding structural conditions relevant for the first review have been met in substance, including all six structural benchmarks.

The considerable improvement in the fiscal position since 1999 (the public sector primary balance turned from a deficit of 2 percent of GNP in 1999 to a surplus of almost 6 percent of GNP in 2001) is very encouraging. It is remarkable that most of the improvement has come from the broader public sector, which had been the source of much of the fiscal pressure during the 1990's. In this framework, we are confident that the public sector primary sector target of 6.5 percent of GNP in 2002 will be achieved. The outlook for public sector debt is also encouraging, since the improvement in confidence and the alleviation of short-term concerns about the public debt rollover has enabled the Treasury to lengthen the maturity of domestic borrowing.

We are pleased that there is now more confidence in the floating exchange rate system, after some resistance of the business and banking communities to abandon the crawling peg. The floating regime gives the CBT greater flexibility in the conduct of monetary policy, and now the authorities can advance in the preconditions for a successful inflation targeting framework. The CBT rightly points out that a track record needs to be built up before a credible introduction of inflation targeting, although here we would concur with staff that a credible disinflation strategy, under a formal inflation targeting scheme, can contribute to lower inflation expectations and brake the effects of the still pervasive backward indexation. We welcome the authorities' intention to launch inflation targeting during 2002.

The recent evolution of inflation allows to be optimistic in achieving the 35 percent inflation target for 2002, but the fight against high inflation is certainly not over yet, and the environment for achieving the target is uncertain. The staff correctly stresses the difficulty of achieving the year-end target, considering the extent of backward indexation and the higher than anticipated oil prices. In this respect, we would appreciate it if staff could further elaborate on how recent developments in the oil market are likely to affect this year's inflation target.

There is no doubt that structural reform will greatly contribute to reduce inflation inertia, and we encourage the authorities to strengthen the efforts to reduce overstaffing and lower wage indexation in the public sector, and to continue the measures to improve the business environment, reduce state ownership in the economy and promote a more market-oriented wage and price setting in the economy.

Challenges for the authorities are formidable. The new program calls for politically difficult reforms, such as reducing public employment, privatizing state enterprises, restructuring private banks, and fiscal and monetary restraint. These measures are to be introduced in a difficult environment: unemployment has increased considerably and—although the authorities have raised and improved the effectiveness of social spending—social tensions persist. In this context, it is encouraging that the authorities have made very important progress to overcome the deep-rooted problems of the Turkish economy, and that they have acknowledged that strict adherence to the program reform agenda is needed for sustained higher growth. We join staff in commending the authorities for the adoption—in a short period of time—of radical reforms aimed at substantially improving the country's banking system and welcome the launching in January 2002 of the voluntary market-based framework for restructuring corporate debt (the "Istanbul Approach"). We strongly favor voluntary and market friendly approaches concerning private sector involvement for the resolution of Turkish difficulties. It is important to stress that the improved market conditions offer an opportunity to advance in the privatization agenda. Continued progress in the country's reform and stabilization efforts undoubtedly enhance Turkey's prospect of joining the EU.

On other issues, we commend the authorities for the measures taken to combat money laundering and the financing of terrorism and we welcome their consent to the publication of the staff's report. Finally, we support the proposed decision, and we wish the authorities every success in their policy and reform endeavors.

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

Introduction

We welcome the encouraging developments since the initiation of the SBA. The benchmark bill rate has fallen, the stock market has risen despite negative effect of regional security concerns, and the foreign exchange rate has been stable. The lowering of inflation, which was seen as key to the success of the SBA when it started, also seems to be progressing, as indicated by the encouraging figures for the CPI and the WPI in February and March. The decline in inflation has resulted in lowered interest rates for government bonds and provided an environment for the central bank to cut interest rates. Recent interest rate cuts were made without disrupting the markets. This encouraging news has improved the confidence of investors in the Turkish economy, and short-term concerns about the public debt rollover have largely abated.

As the scenario envisaged when the program started is now being realized, the focus should now be on how to manage the tradeoff between business activity and inflation. In this context, it is still unclear whether the recovery projected under the program will actually take place. Indicators on the supply side are mixed, and in particular industrial production was still not recovering as of February. Moreover, there remain risks, such as regional security concerns owing to Turkey's location and uncertainty about the prospects for oil price developments. The authorities need to find a way to recover production without jeopardizing inflation expectations. In the short term, an improvement in confidence through the demonstration of strong restructuring of the banking and corporate sectors, as well as sustained fiscal discipline and prudent conduct of monetary policy, are necessary conditions for the recovery of production and consumption. In the long run, a boost in productivity through structural reform is necessary to realize sustained growth. Especially under the floating exchange rate regime, currency appreciation would have a positive effect on containing inflation, but would risk harming economic growth because of its negative effect on competitiveness. It is important to compensate for the negative effect of currency appreciation on growth by improving domestic productivity.

Fiscal Policy

The strengthening of fiscal discipline in the last few years is commendable. It is especially heartening to learn that most of the recorded improvement has come from outside the central government, where there has been much fiscal pressure in the past. The fiscal discipline has improved confidence in fiscal sustainability, and has contributed to the strengthening of public debt management by lengthening the maturity of domestic borrowing and increasing access to international capital markets. Maintaining this fiscal discipline in the medium term is essential for the success of the program. To achieve the primary surplus targets comfortably, key fiscal reforms, such as restructuring of redundant state economic enterprises, tax reform, and revenue administration measures, have to be implemented as planned.

Monetary Policy

The CBT's monetary policy management, using base money as monetary targets, has started to lower inflation expectations. However, it is still unclear whether lowering inflation to 35 percent by end-year is achievable, and the recent increase in oil prices is posing a new risk to the prospect. We advise the authorities to proceed with interest rate cuts prudently, while closely monitoring the developments in inflation expectations. It is welcome that technical preparations are progressing toward introducing formal inflation targeting. But since the inflation targeting would have only a limited effect if the credibility of the target is not ensured, other preparations have to be made, such as elimination of backward indexation. After a little more than a year, the floating foreign exchange regime seems to have been accepted by participants in the Turkish economy. We urge the authorities to continue to refrain from unnecessary interventions and to maintain transparent foreign exchange management.

Banking Sector

As the restructuring program for state banks and banks in which the SDIF has intervened is well advanced, the biggest challenge for the banking sector has become the rehabilitation of private banks, which form the core of the banking system. It is encouraging that the authorities have set up a scheme to recapitalize banks under stringent conditions, and are steadily implementing the rehabilitation process. Debt restructuring of the corporate sector has to be dealt with in parallel with dealing with non-performing loans in the banking sector, since it is the other side of the same coin. In this context, it is encouraging to know that this issue is being tackled using an out-of-court process based on the voluntary, market-based Istanbul Approach for the largest borrowers and asset management companies for medium-sized borrowers, and that debt restructuring for small borrowers has already started.

Despite these efforts by the authorities to restructure the banking sector, real bank credit to the private sector has been declining. If this weak credit provision continues, it is likely to have a negative effect on the recovery of economic activities. Bank credit remains weak while the capacity utilization rate and business confidence have recovered, so it seems like the primary problem lies in the banking sector. In this context, we urge the authorities to implement banking sector reform quickly. In any event, we would like to ask staff why bank credit to the private sector continues to be weak, and what the prospects are for a turnaround of the current trend.

It is encouraging to see a program with such large access to Fund resources staying on course. However, the risk remains whether economic growth will rebound as envisaged in the program. The current virtuous cycle could be reversed if there are signs that program implementation has been weakened. We urge the authorities to continue the reform efforts without complacency, and we wish them every success.

Mr. Bennett submitted the following statement:

Turkey should be commended for the strong progress it has made in implementing the highly ambitious Fund-supported economic reform program. The ambitiousness of the program, however, is understandable—in early 2001 Turkey was facing an unmanageable public debt, and one of the highest inflation rates in the world. One approach to getting the economy on a sustainable footing would have been to undergo major debt restructuring. Instead, the authorities and the Fund chose to utilize a catalytic approach. The hope is that the combination of Fund financing and economic reforms will boost market confidence enough so that Turkey will be able to grow its way out of its heavy debt burden. The challenge in the catalytic approach is whether growth comes sufficiently quickly to produce rewards that encourage citizens and politicians to stick with reforms and generate a virtuous circle. It is through this lens that we examined the First Review under the Stand-By Arrangement.

Staff Report may be Overly Optimistic

It is clear that Turkey is in the "honeymoon" phase of the catalytic approach—all parties have shown considerable commitment to undertaking reforms, and in return investors have shown some confidence in Turkey, and the inflation rate has been brought down significantly. This good news is appropriately highlighted in the staff report. The staff report also discusses the concern over the poor prospects for near-term growth – but staff is still hopeful that 3 percent growth can be achieved this year, followed by 5 percent real growth in subsequent years. Overall, the report portrays the situation as "everything is on track, except perhaps for growth".

We think this characterization could be overly optimistic. A more accurate depiction of what is going on may be "growth is failing, despite the good news on other fronts". Without a speedy return to growth, Turkey and the markets could lose patience with the ambitious reform agenda.

Stagnant Growth was Predictable

Turkey's Fund-supported program is unlikely to produce a quick rebound in growth. The idea of an export-led rebound has been abandoned by the staff since the last review, and there is growing worry that a steadily appreciating real lira, higher oil prices, and geopolitical turmoil may transform the external sector into a net drag on Turkish growth. Both capacity utilization and industrial production have been generally flat. While massive structural reform in the critical spheres of the economy will bolster Turkey's long-run prospects if they are adequately implemented, the immediate consequences of the privatization and restructuring of state enterprises are clearly contractionary. Domestic interest rates are prohibitively high that one cannot count on significant domestic investment in the near term. FDI-led growth still seems a good way off, as do the prospects for EU accession.

The staff scenario for a recovery in 2002 is not convincing. The staff explains that this year's growth target can still be reached, thanks to a rebound in consumer demand and inventory replenishment. But we wonder how household spending can be expected to rebound 3.8 percent with the planned lay-off/early retirement of 40-60,000 public employees in addition to the job losses implicit in the planned closure of hundreds of state bank branches. Moreover, consumers are facing tight credit conditions with high real interest rates that make a near-term spending surge unlikely. In addition, corporate bankruptcies may continue to rise in the current environment, with implications for commercial banks' balance sheets.

The contraction in the economy—and poor prospects for immediate growth—should not come as a surprise in the Fund's catalytic approach. It is a scenario that we have seen before in countries where radical reforms are necessary: cut spending, raise taxes, control inflation, and hope that real interest rates fall and growth picks up soon enough.

Signs of Slippage in Structural Reform

But if growth does not pick up soon, this could undermine the reform process and market sentiments. We are already seeing some signs of a weakening political will to implement the program—and this should have been pointed out more forcefully in the staff report. The abrupt retirements of the head of the governing board of the state banks Halk and Ziraat, and the firing of Turkey's head of privatization are worrisome. Even more worrisome are the signs of reduced government commitment to reform as evidenced by the recent comments by the Prime Minister, who has publicly indicated that the independent agencies recently created to regulate or manage key sectors of the economy have overstepped their limits and should be reined in. He went on to suggest a greater role for the government in the decisions of these agencies, a move that would clearly undermine their independence. The PM then proposed a law that would allow the heads of these agencies to be appointed by a single minister rather than by the Cabinet as a whole, a move with potentially disturbing consequences.

We are concerned that the report does not emphasize these developments. Autonomous agencies, particularly in the banking sector, form the backbone of the Fund's program. We would have liked to have seen more frankness from the staff. With the risk of reform fatigue and evidence of less than adequate political commitment beginning to surface, Fund vigilance is required more than ever.

Implications: Contingency Plans and Perfect Implementation

So, what is the upshot of this? What if Turkey is stuck in a prolonged low-growth equilibrium? We would argue that there are two implications. First—as we suggested at the last Board meeting on Turkey—a detailed contingency plan is necessary to deal with the possible failure of the catalytic approach. The catalytic approach leaves little policy flexibility to stimulate growth given Turkey's debt and inflation concerns, and growth just may not kick in quickly enough to keep the program on track and avoid another economic crisis. This is in the nature—and shows the limits—of the catalytic approach. Second, it underscores the need (again) for perfect implementation of reforms by Turkey and enhanced vigilance by staff in monitoring and assisting in the reform process. Continued adherence to the macroeconomic targets are needed as well as greater efforts to strengthen the banking sector and faster progress on privatization in general. Unless the government is fully engaged on all fronts, one cannot expect a return of investor confidence so that real interest rates come down and spur economic growth.

Let me focus the remainder of my remarks on two additional areas of policy implementation. One, delays in the implementation of an inflation-targeting regime remain perplexing—and could have destabilizing consequences. The central bank appears to have the technical skill to set-up the system, the legal autonomy to do so, as well as complete control of overnight rates. Without a credible nominal anchor, inflation expectations could well rise rapidly if either the lira begins to depreciate or oil prices remain at their current high levels. This is especially true given the lack of progress on the government's incomes policy. Backward-looking indexation remains a major feature of the Turkish economy, and even state enterprises continue to price many of the public goods according to this method. Given the importance of generating a sizeable primary surplus, the government appears to be refraining from pushing for reform in the public pricing mechanism. We urge the authorities to move quickly to introduce inflation-targeting and eliminate indexation.

Two, regarding the banking sector, it appears that some commercial banks are again increasing their foreign currency exposure and investing in higher-yielding lira-denominated government debt. As you will recall, it was precisely this type of incautious behavior that precipitated Turkey's banking crisis. Heightened efforts in the area of bank supervision and regulation including banks' open foreign exchange positions are warranted.

Conclusion

The staff report sets out both the significant accomplishments of the Turkish authorities, and the risks of program failure. We would argue, however, that a case could be made that the emphasis is not quite right—the staff is not frank enough in assessing the attendant risks of poor near-term growth prospects. The program provides no freedom to stimulate growth, and lack of growth could undermine the support for reforms. This more pessimistic perspective argues for even more commitment to perfect program implementation and the development of a contingency plan, should the catalytic approach fail.

Mr. Cippà submitted the following statement:

Since the last review, the Turkish authorities have managed to keep the program on track and to make further progress with structural reforms. Market access has been better than expected, and inflation—although still high—is lower than predicted. The central bank has been able to build up foreign exchange reserves by taking advantage of a better than expected balance of payments position. All this is great news for which the authorities deserve praise.

At the same time, it is important to acknowledge that this is an exceptional program in an exceptional situation requiring an exceptional effort by the authorities. It has been the view of this chair from the beginning that this arrangement will only succeed with very hard work and a good share of luck. Given that the risks to the program are still large, nobody should be surprised if I use the remainder of my statement to elaborate on those areas in which more hard work is needed.

Prospects for Growth

The staff admits that downside risks to growth have increased. It nevertheless maintains the projection of 3 percent GNP growth for 2002 which seems to be significantly above those of private forecasters. I would have liked a more extensive analysis of the factors determining the prospects for growth, even though I appreciate the information provided in Box 2.

It is clear that the program is unlikely to succeed without growth picking up. In this respect, the medium-term outlook presented in Box 2 is not reassuring. First of all, the competitive advantage following last year's devaluation is eroding and exports are not expected to be a source of growth in 2002. Second, the main factor of growth in 2002 is supposed to be inventory accumulation. This is rather puzzling to me since I would not usually expect inventories to be a major contributor to growth, particularly in absence of resuming consumption. Third, and maybe most importantly, the high corporate debt burden is holding back investments. As staff rightly urges, the authorities must move forward with corporate debt restructurings so as to allow investment activity to resume. In this respect, more information on corporate debt and the health of corporations in general would have been welcome. Last but not least, Turkey is an oil importer and risks being negatively affected by higher oil prices. Again, some estimates as to the effect of higher energy prices would be interesting.

Fiscal Policy

With debt restructuring being excluded, maintaining the targeted primary surplus is key to the program's success. I thus find it disturbing that a waiver of applicability is being requested, particularly since the staff's comment that the respective performance criteria is "likely to have been met" does not sound overly reassuring. I would have much preferred to postpone the review until the data is available. I can only reluctantly agree to grant the waiver.

Almost as important as reaching the targeted fiscal surplus is how this is done. The staff notes that the adjustment at the central government level has relied almost entirely on revenue enhancement and that the budget still relies extensively on distortionary taxes. It is regrettable that there appears to be a slow-down in progress to improve the tax system since this would be an important contribution to sustainable macroeconomic policies. I note that the authorities expressed concern about aggressively reducing tax distortions on interest income in the context of the April reform, preferring to deal with it—and the related revenue implications—in the context of the tax reform planned for October. This seems to imply that they currently do not see any alternative way to achieve the fiscal targets, either by generating revenue or reducing expenditure. Moreover, the authorities have introduced new tax incentives and I wonder whether the staff has any estimates of their fiscal effects.

On the expenditure side, major progress is expected from the structural reforms in state economic enterprises (SEEs). Yet, I miss information about the estimated fiscal effects of these reforms. Does staff have any cost estimates for the schemes that have been offered to workers for early voluntary retirement? Are there estimates for the savings from these measures, and if so, on what number of redundant workers are they based? Furthermore, the prior action to identify all redundant workers and positions in SEEs has not been fulfilled entirely. Rather than presenting final by-company estimates, only an aggregate study has been produced. This delay is unfortunate because timely progress on this crucial issue is important.

Monetary Policy

Regarding the monetary policy framework, I welcome the progress made toward meeting the preconditions for successful inflation targeting. Unfortunately, discriminatory taxation and confusing reserve and liquidity requirements continue to distort and hinder the development of the money and foreign exchange markets. At the same time, I welcome the agreement reached to eliminate the stamp duty on forward contracts as well as the tax on inter-bank foreign exchange transactions.

I note from Mr. Kiekens' and Mr. Çakir's preliminary statement that the authorities would like to make further progress before announcing an inflation targeting framework, including a longer track record of inflation reduction. While the staff's case for the need to break the inertia of inflation expectations (Appendix IV) is quite convincing, there are also arguments against an instant introduction of inflation targeting. My main worry is that the recent success in fighting inflation is for the greater part due to the larger than expected economic downturn. While inflation expectations seem to have come down, it may be prudent to wait for a firmer track record to be established. In this respect, I would be interested to know from Mr. Kiekens and Mr. Çakir what kind of track record they would view as appropriate and what other preconditions they judge necessary to be in place. Finally, I wonder whether the high degree of dollarization in the Turkish economy might not pose a serious risk to successful inflation targeting.

Contingency Measures and Medium-term Scenarios

I appreciate the presentation of two alternative scenarios for the medium-term economic outlook in addition to the baseline scenario. However, I would have appreciated a more detailed sensitivity analyses and maybe even some judgment about the respective probability of each scenario. Furthermore, at the last Board discussion in February, several directors encouraged the staff and the authorities to discuss possible alternatives in case the program encounters problems. Given the clear risks to the program, this would seem more than warranted. I would appreciate staff's comments on the issue of contingency measures.

Various Issues

Regarding private bank restructuring, paragraph 31 of the report states that the targeted valuation of bank portfolios to get reliable estimates of banks' net worth would be completed by end-March. Can staff confirm that this has been done? A reliable estimate of the banks' net worth will be a crucial step toward the goal of banks' recapitalization, and I urge the authorities to continue with the necessary actions according to the agreed schedule, so that the final interpretation of the evaluation will be completed by end-April and banks will be informed by letters on the required actions by May 15.

Regarding privatization, the conditionality does not include actual sales. In Box 5 on structural conditionality the staff notes that this approach is appropriate "at present, given the current unfavorable market conditions". But in its appraisal, the staff urges the authorities that privatization must be sped up since "market conditions are more favorable now". In view of the improving market conditions, does the staff intend to extend conditionality to actual sales?

Further on conditionality, I note that the program continues to set prior actions for future reviews. In our view, it would be preferable to change them into performance criteria. This would put greater stress on the importance of timely progress and it would make explicit waivers necessary in case of non-fulfillment before the Board meeting.

It is commendable that the authorities have regularly consented, ahead of the respective Board discussions, to the publication of the Board documents. Unfortunately, this has not always resulted in the actual and timely publication. The reports of the sixth/seventh and the eight review under the previous program were posted on the Fund's website with a delay of almost one month. The report for the ninth review (August 2001) was never published—without any explanation. The report for the tenth review (November 2001) was not published until February 15, 2002, and the report for the request for SBA (February 4) has yet to be put on the website. I would appreciate staff's comments on this.

To conclude, in view of the continued efforts of the Turkish authorities and their commitment to the program I support the completion of the first review.

Mr. Kelkar and Mr. Jayatissa submitted the following statement:

Key Points

We welcome the progress being made towards macroeconomic stability and structural reforms.

We underscore the need to firmly establish a sustainable reduction in inflation before announcing a date for formal inflation targeting.

An erosion of competitiveness should be avoided through careful monitoring of real sector developments as well as exchange rate trends.

We welcome the progress made in bank restructuring and endorse the need to maintain the momentum of the process.

At this stage reduction of redundancies in the public sector should be done through VRS rather than layoffs.

Development of debt situation should be carefully monitored and debt management strengthened.

We thank the staff for the well written report and Mr. Kiekens and Mr. Çakir for the helpful preliminary statement. We also commend the authorities for the progress they are making in macro-economic adjustments and in structural reforms.

The progress made under the program is encouraging. The confidence building process is underway and it is particularly pleasing to hear that both inflation and inflationary expectations have declined. We note that the staff report is firmer about the possibility of preconditions for formal introduction of inflation targeting to be in place by midyear. We agree with the CBT that there is a need to establish a longer track record of inflation reduction before announcing a starting date. In this regard, we endorse the need to sterilize the monetary impact of foreign exchange purchases. This is particularly important because there are several other factors which could exert price pressures as indicated in the staff report. While it is clear that market will prefer more short-term investment with the CBT, what are the possibilities of CBT offering different maturity structures to the market participants or is it already happening? We would welcome staff's comments.

We are also concerned whether the recent appreciation of the Lira would cause a significant erosion of competitiveness. We would appreciate staff's comments on whether the current combination of real interest rates and exchange rate is around the right balance. It would be important to avoid an undue appreciation of the exchange rate.

We welcome the progress being made in the bank restructuring efforts and the preparations underway for next phases. While recognizing the difficulties in the process and the possible delays, we also share the view that momentum of the reform process needs to be maintained.

We welcome the completion of the macro-level study on state economic enterprises and authorities plans to expand the scope to identify the redundancies in the central government. While due recognition should be given to the authorities preference for avoiding layoffs, we are pleased that satisfactory progress is being made in their plans for reducing redundancies though early voluntary retirements.

It is encouraging that significant progress is made in fiscal consolidation. As there appear to be renewed concerns about the debt situation due consideration should be given to the downside risks mentioned by the staff. To further enhance the confidence, as the staff has rightly pointed out, through efficient debt management authorities need to convince the markets that debt situation remains under control.

We support the completion of the review and wish the authorities all success in their economic policy endeavors.

The staff representative from the European I Department (Mr. Kähkönen) informed Directors that the staff had received fiscal data for the central government prior to the start of the current discussion. The data showed an over performance of about 0.3 percent of GNP on the revenue side in the first three months of 2002, suggesting that the fiscal program remained fully on track.

Mr. Isleifsson made the following statement:

Turkey's performance under this program has been encouraging and we support the completion of the first review. The authorities should be commended for their successful stabilization efforts and their progress in implementing the structural reform agenda. We would also like to welcome the constructive cooperation between the authorities and the Fund and thank staff for their hard work in assisting Turkey. I welcome the new information given by staff that the fiscal program remains fully on track.

At the same time, there is still a long and difficult way to go, and serious risks remain. Some recent signs indicating that the political support for reforms may already be wavering are a matter of concern, which I will come to later. This exceptionally large program requires exceptionally strong and sustained efforts. Moreover, I agree with other Directors' call for further stress testing and appropriate contingency planning.

Raising Turkey's medium-term growth is a central objective of the program. Although growth performance has been disappointing so far, we believe that the growth target for this year may not be out of reach, if only for the reason that it is a relatively modest one. The faster than expected decrease in interest rates should be helpful in this respect, but we agree with the staff that the risks may have shifted to the downside.

High inflation has been one of Turkey's main economic problems for a long time, and it rose substantially in 2001. The recent downturn is a hopeful sign, as well as the lowering of inflationary expectations. It looks increasingly likely now that the 2002 target for inflation will be met. The strengthening of the lira has, of course, contributed to this positive development. But it is much too early to be confident that inflation will continue to fall, and we urge the authorities to keep up their efforts to fight inflation. If the inflation inertia is to be broken, measures even more vigorous than those envisaged in the program may be required. This view seems to be underscored by the staff's lucid analysis of the inflation process in Turkey.

We agree with staff that maintaining fiscal policy restraint is crucial to bring inflation down, and we commend the authorities for their impressive fiscal policy performance. But the overperformance in tax revenue confirms our belief that there is room for increasing the primary fiscal surplus by more selective government spending and by pushing forward with privatizations as recommended by the staff.

Obviously monetary policy also has an important part to play in combating inflation. I welcome the significant build-up of reserves and agree that this is important in enhancing confidence. I agree with the staff that the monetary impact of foreign exchange inflows needs to be sterilized. Furthermore, I welcome the information in Mr. Kiekens' and Mr. Çakir's comprehensive preliminary statement that the CBT intends to make the necessary preparations in order to be able to launch formal inflation targeting before the end of this year. A third important factor is wage formation, and I reiterate our view that a discontinuation of wage indexation is vital for lasting success in bringing down inflation.

Progress on structural reforms has likewise been commendable, although more uneven than in the macroeconomic stabilization area. We welcome the progress made in putting Turkey's troubled banking system on a sound footing. The achievements so far in restructuring the state banks are good steps forward and we welcome the information that the restructuring of private banks seems to be going according to the agreed strategy.

At the same time, some signals of wavering support for some of the structural reforms have not escaped our attention. I concur with Mr. Bennett, who in his preliminary statement lists some events and statements to this effect, that Fund vigilance is of utmost importance in this case. We are now approaching a critical phase, when the true values of the loan portfolios and the Banking Supervision and Regulation Agency (BRSA) will establish the resulting needs for capital injections and communicate them to the banks. This will test the commitment of the Government. It is of the utmost importance in restoring the confidence in the banking system that the BRSA is allowed to act independently according to the restructuring strategy outlined in the program, that the conditions for state support are strictly adhered to, and that no deviations from international standards are accepted.

As pointed out in the staff report and reiterated in Mr. Kiekens' and Mr. Çakir's preliminary statement, corporate sector restructuring is a vital complement to the rehabilitation of banks. Progress in this area has been slow so far, and a faster tempo is required; otherwise the positive effects of recapitalization of the banks will be jeopardized. It is important that restructuring is done in a way that makes companies start servicing their debts to the banks, be it on a modest scale, instead of just prolonging maturities and grace periods.

We strongly agree with staff that privatization of state enterprises has to be speeded up. This is crucial for both growth prospects and the success of fiscal policy.

The safeguards assessment is valuable. We support including some of the actions identified in the assessment under Fund conditionality, not least in view of the high exposure of the Fund to Turkey. In light of this exposure we would be interested to hear the staff's views on how the forthcoming large repurchases by Turkey will be financed. This exposure also makes Article IV consultations with appropriate intervals essential, in addition to the program reviews. It is of concern that more than two years have passed since the last Article IV consultation on Turkey. As emphasized in connection with our recent biennial surveillance review, it is important to ensure that the necessary "stepping-back" exercise associated with a full-fledged Article IV consultation is undertaken in a timely manner.

Although the waiver may not be needed in light of the positive information provided by staff at the start of the meeting, we regret being asked to grant a waiver in the first review of such a large program on something as significant as the primary fiscal balance.

Finally, we welcome the authorities' decision to publish the staff report. We wish them continued success in their efforts.

Mr. Padoan made the following statement:

We thank staff for this very well written report and Mr. Kiekens for his exhaustive preliminary statement.

We fully support the proposed decision and we congratulate authorities for their action. We also appreciate staff's effort in presenting an articulated and comprehensive program, as well as the division of labor between Bank and Fund in treating structural conditionality.

Recent performance of the Turkish economy is encouraging. Markets are responding according to, and possibly above, expectations, as indicated by the steady decline in interest rates and the recent Eurobond issuance. However, concerns remain about the possibility to meet this year growth target, as forecasts different from those of staff suggest.

Needless to say, challenges remain strong, both at the macroeconomic and structural levels. Action at both levels will have to target sustained growth, failing which debt sustainability is unattainable.

Macroeconomic stabilization requires strong action both in the fiscal and monetary areas.

Fiscal policy is called upon to obtain, and maintain, a substantial primary surplus, requiring further improvement in tax management and expenditure cuts. Recent measures to shed excess employment in the public sector are appropriate, however, I am concerned by the fact that the prior actions on the identification of the number of excess workers has not been met and, in the Report, we are only presented with estimates.

Monetary policy will have to continue to progress in its fight against persistent and sustained inflation. Success in this area will lead to a decline of inflationary expectations, thus paving the way for a move to inflation targeting, the adoption of which should possibly be accelerated.

It is hard to imagine that the necessary disinflation process will come at no cost. The detailed analysis in the Appendix contains some reassuring message as to the shift towards a more forward-looking behavior in price formation. However, this is particularly, and unsurprisingly, true for the tradable sector. Less so for the non-tradable sector, the behavior of which is largely responsible for the long inflationary inertia.

I agree with staff that persistence of inflation reflects structural components. Precisely for this reason, reaching the one-digit inflation range, as requested in the program, will require a "structural break" in inflationary behavior. I suspect that this could entail output costs that might be larger than expected, as describe in the report. I would like to hear staff comments in this respect.

A related aspect is exchange rate behavior. The report discusses at length the implications of exchange rate appreciation for external competitiveness and comes to the conclusion that external balance would not be endangered by further appreciation.

Nonetheless, the recent fall in export share is a source of concern, more so given that, in the short term, exports should represent an important contribution to growth.

I am not saying—of course—that Turkey should pursue competitive devaluations, as competitiveness rests on appropriate labor cost evaluation. I am concerned about the possibility of a sustained appreciation trend, as has happened in the past, that could lead to sharp and undesirable reversals. Again, staff comments would be appreciated.

To offer some ideas of the risks involved in the program, the report appropriately contains alternative scenarios.

Scenario 1 in the Staff Report—reform fatigue—depicts the negative effects of failure to implement a strong performance. I appreciate the analysis; however, it would be interesting to know from staff whether, in such a scenario, any particular component is responsible for the outcome or is the blame equally to share between structural and macroeconomic failures?

Whatever the case, strong macroeconomic performance and structural reform need to complement each other. The ultimate goal, as I mentioned above, being that of bringing Turkey to a sustained and sustainable growth rate as envisaged in the program. We concur with staff (and with Mr. Kiekens) that this requires substantial increases in factor accumulation and total factor productivity. Turkey enjoys—according to available evidence—a significant degree of labor market feasibility. A solid and well-functioning financial market will support the formation of private savings and capital accumulation. This, however, will only be a necessary condition for faster growth. Increase in productivity will also require a strong contribution from innovation diffusion.

As in other country cases of high growth, including many of the countries facing the prospect of EU membership, significant FDI inflows have been key in this respect. The very limited amount of FDI Turkey has enjoyed up to now signals, on the positive side, the potential benefits of quickly moving towards an investment-friendly environment. On the negative side, it signals that Turkey still has some way to go in convincing international investors. It is particularly worrying, in this respect, that the process of privatization is moving very slowly, if at all.

The staff report is silent in this regard. More information on the government’s privatization programs would have been very welcome. In addition, I find that the report is not particularly illuminating on the strategies for corporate restructuring. I look forward to the next review for a deeper examination of the issue.

Finally, moving on to a higher growth path will require important structural transformations, most notably in the agricultural sector, which will have to decline to align with international averages. This process has so far been held back by lack of reforms and liberalization. The issue will have to be tackled, and it will also bring additional costs. Also, but not only, for this reason, it is appropriate that authorities continue to target social expenditure, so as to minimize the negative impact of the program on the weaker components of the population.

The Turkish authorities have to be commended for their endeavor to implement the program in the face of very substantial support from the international community. Political difficulties, both domestic and international, will continue to put this commitment to severe test. We are confident that the tests will be passed.

Mr. Couillault made the following statement:

I thank staff for an interesting report and Messrs. Kiekens and Çakir for their very instructive and comprehensive statement, which appropriately reminds us of the progress achieved since 1999. After a difficult year, Turkey is now reaping some benefits from the difficult decisions taken in order to achieve the targets defined in the program. Indeed, inflationary pressures are easing and interest rates are now clearly on a downward trend. However, while financial market conditions have improved markedly, the growth performance remains disappointing. Impressive results have been achieved in the conduct of fiscal policy, as confirmed in the update provided by the staff representative from the European I Department. While Turkey is on the right track to achieve the ambitious primary surplus target included in the program, additional progress is needed in terms of tax reform, expenditure control, and privatization, as already mentioned by other Directors. We encourage the authorities to accelerate the implementation of measures in this area.

Given the large amounts of Fund resources committed to support the program and the disappointing private sector involvement (PSI), we should take the improvements in financial markets with a grain of salt, and not underestimate the role played by the abundance of public funds, in particular given the front-loaded nature of the arrangement. We also note that the current account balance has been revised upward for 2001, which sheds a different light on the external financing needs. Therefore, while the situation is improving, the authorities should pursue their efforts, and in particular we have four main areas of concern.

First, as pointed out by Mr. Duquesne during the previous Board discussion on Turkey, we remain skeptical on the ability of the Turkish authorities to achieve simultaneously a 6.5 percent fiscal primary surplus and a 3 percent growth rate. Many other Directors, and in particular Messrs. Yagi, Bennett and Cippà have expressed similar concerns. No doubt, reviving growth while curtailing inflation is one of the main challenges of the program. However, a 3 percent target for growth appears somewhat optimistic, given the major fiscal retrenchment in the context of bank and corporate restructuring, the high real interest rates, the appreciating currency, and the rise in the cost of energy products.

Second, while we are ready, like Mr. Mirakhor, to commend the authorities for the unwavering commitment to the program, we should also keep in mind that the political commitment often weakens when economic pressures ease. Since Turkey has a long history of political quarrels frightening markets and destabilizing economic programs, we urge the authorities to maintain the cohesion of the coalition. In that regard, recent events have not been encouraging, and I am not referring only to the prime minister's comments on the independent authorities. As we stressed during our previous Board discussion, this program is ambitious, and it leaves no alternative to the authorities but to stick strictly to the program. This will be particularly difficult when the authorities face difficult decisions with regard to the significant amount of redundant workers in state economic enterprises. Clearly, appropriate safety nets are needed, and we welcome the efforts undertaken in collaboration with the World Bank in this domain. The implementation of the unemployment insurance system, which began to operate last month, should be commended.

Third, against the backdrop of the Turkish lira's appreciation, we welcome the staff's analysis on competitiveness, and we share their views that a moderate depreciation of the lira could be compatible with the success of the program. Indeed, against the backdrop of a still high inflation rate, there is a need to resist to the temptation of relying on currency depreciation to boost the economy's competitiveness, as the best way to buttress the competitiveness is to accelerate structural reforms and encourage private sector development. Given the low level of net international reserves, which are still negative, we share the staff's view that the Central Bank of Turkey (CBT) should use the better-than-expected balance of payments position to build up foreign exchange reserves. In this context, the daily auctions to purchase foreign exchange reserves should continue, with the understanding that they should be sterilized and not viewed as a way to influence the evolution of the lira.

Finally, we have repeatedly expressed our concern with regards to the situation in the banking sector. We note that the three-stage process to address the issue of rehabilitating private banks is underway. We share the staff's opinion that there is a need to maintain the momentum of the process, and we urge the authorities to maintain the pressure on banks to respect the schedule. We also welcome the recent warning issued by the CBT on the risks associated with open foreign exchange positions. Indeed, the banking sector has been at the heart of the two main crises threw the 1999 program off track. Significant progress has been achieved, but much remains to be done and there is a need to overcome the reluctance of private banks. The recapitalization scheme will only be fruitful if conducted in a transparent manner, and accompanied with parallel corporate restructuring. Clearly, bank and corporate restructuring—including the unwinding of the so-called "liaison control" between the banking sector and the corporate sector—are preconditions for a strong and sustained recovery.

To conclude, we still have some doubts on the possibility of achieving all the targets of the program, but we would like to commend the authorities for their efforts, and we support the proposed decision and the requested waiver of applicability.

The staff representative from the European I Department (Mr. Kähkönen), in response to questions from Directors, made the following statement:

Let me start with a question that was raised in Mr. Cippà's statement and was also referred to by Mr. Isleifsson, namely what contingency measures could be considered if the program encounters problems. The program has been designed to withstand shocks better than previous programs, with a floating exchange rate, a tight fiscal stance, and inflation targeting helping bring about macro stability. The program aims to address the key structural weaknesses that have caused problems in the past, it is based on conservative assumptions, and it has obtained better-than-anticipated results thus far. There is some cushion in accumulated reserves, the fiscal program is over performing, and interest rates are already almost 10 percentage points below the assumed annual average for this year.

Moderate shocks can be absorbed under the present program without the need for additional measures, although the authorities have already demonstrated during the previous year that they can introduce additional measures on the fiscal side if needed. Possible shocks to the program could be external, or domestic if there is political pressure to relax policies. The response to the domestic shocks would be in line with what the Board, management, and the staff have repeated time and again, namely strict implementation of the agreed program. As for the external shocks, they would in the first instance be mitigated by exchange rate fluctuations. Additional measures would depend on the permanent or temporary nature of the shock, and on its magnitude.

Relating to the various possible shocks, Directors posed questions on the effects of the higher-than-projected oil prices, which are are about 25 percent higher in the latest WEO than assumed when the program was formulated at the end of 2001. The direct impact on prices is on the order of 2 to 3 percentage points, according to central bank estimates. However, this should not derail the inflation target, given the stronger-than-programmed exchange rate.

Mr. Padoan asked about the costs of disinflation. Typical measures of such costs like sacrifice ratios are not necessarily applicable in the case of Turkey. Output costs depend on the factors dirving inflation expectations. In

Turkey, sticky expectations appear to be a more important factor than structural rigidities, and achieving the 35 percent target should be feasible without significant output losses if the trend of rapid reduction in inflation expectations seen in the last two months continues.

Continuing with the questions in the statements, Mr. Wei asked about the fiscal costs of the ongoing bank restructuring exercise, and whether these costs have been taken into account in the budget. The costs will only be known when the exercise of finding out what the capital requirements are is completed, and when it is clear how much the owners themselves can raise from private sources. The expectation when the program was formulated that the cost to the public sector would be within the contingency of 2 to 3 percent of GNP remains valid. This expectation was incorporated in public debt estimates prepared at that time.

Regarding Mr. Cippà's question about the estimated effects of the tax incentives recently introduced to stimulate job growth, the estimated cost is about 0.1 percent of GNP. Similarly, regarding the cost of the early retirement schemes and the savings achieved, the fiscal program for 2002 makes the conservative assumption that 25,000 retirements will take place voluntarily. That would mean a severance pay of 0.2 percent of GNP, and net savings to the budget in wages of about one third of that. This is a conservative estimate, and if the tentatively identified numbers hold, and the reductions in staffing take place, the severance pay would be about twice as much, and the savings to the budget would also increase. These savings basically mean that the severance pay would be covered within about three years.

On Mr. Kelkar's question regarding the lengthening of central bank maturities, this has already started. The central bank is now conducting weekly auctions of four-week central bank deposits, and this will help the sterilization process. It is not expected that the central bank would move beyond the three-month instruments, as it does not want to compete with the Treasury.

Mr. Cippà also asked about the health of the corporate sector, and whether there are data on corporate debt. The data are not very good or comprehensive, and for this reason, the program envisages that the authorities will make efforts in this area, and come up with a database in the next few months. Even though no accurate data are available, it is fairly evident that the corporations in Turkey are not as indebted as in the Asian crisis countries. The debt-to-equity ratios peak at 100 to 200 percent, and the ratio of private sector credit-to-GNP is quite low in Turkey.

Mr. Padoan clarified that his question on the costs of disinflation referred to the higher costs associated with reducing inflation to one-digit figures, which did not appear to have been taken into consideration adequately in the analysis provided in the staff report.

The staff representative from the European I Department (Mr. Kähkönen) responded that the program envisaged reaching single-digit inflation figures after the end of the current program, following a period of gradual disinflation, and that it was still early to assess the output costs associated with achieving such low inflation figures.

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

> On questions of a more general policy nature, Mr. Cippà has recommended the use of structural performance criteria rather than prior actions in future program reviews. First of all, it should be recognized that, in the case of Turkey, prior actions are not used in the conventional sense of, for example, helping to negotiate the resumption of a program that has gone off track. In the case of Turkey, prior actions are specified ex ante for the completion of the review. A similar use of prior actions in program reviews has been made in other cases to highlight issues of particular importance among the various issues that require progress to complete the review. In addition, prior actions provide more flexibility than structural performance criteria regarding the timing of the measures to be completed. In this regard, prior actions have operational similarities with structural benchmarks. Their flexibility is particularly important in the context of the dynamic and complicated reform process in Turkey. Finding ourselves hostage to the various dates set for structural performance criteria could be a problem given the broad range of measures covered under the program's reform agenda.
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> Such considerations notwithstanding, we are revisiting the use of prior actions for program reviews, as it remains unclear whether they represent a significant improvement to alternative means of program monitoring. We will carefully consider this issue as we look at the guidelines on conditionality, and it is likely that the use of these instruments for program reviews will not be encouraged, which would be consistent with the rare use of this instrument in the past. Although this issue is still under consideration, it appears clear that most circumstances can be handled through other instruments, like structural performance criteria, review clauses and/or structural benchmarks, which allow for a more systematic review process.
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> On the related issue of the waiver of applicability of the performance criterion on the cumulative primary balance of the consolidated government sector, I understand Mr. Cippà's and Mr. Isleifsson's concern at the request of the waiver. While waivers of applicability should generally be discouraged, the performance criterion involved is not relevant for this particular review. In addition, delaying the review for one month to wait until the data is available would severely disrupt the tight two-month cycle scheduled to monitor the implementation of Turkey's Fund-supported program. Moreover, as the staff representative from the European I Department has already explained, all the available evidence suggests that the performance criterion will be satisfied.

> Finally, on Mr. Cippà's question related to the publication of the staff report, the main reason for the delays in publishing staff reports after Board discussions on Turkey is related to the deletions policy. In this regard, Turkey is not an unusual case, as negotiations held with the authorities to identify market sensitive information that should be deleted from the reports before publication can be protracted. Under the Fund's policy of deletions, the staff tries to keep deletions to a minimum, and there are normally discrepancies with the authorities as to what information should be considered as market sensitive. These issues will be discussed at the Board in the upcoming review of transparency, and it should be possible to see in the data provided for that review whether the delays are longer than average in the case of Turkey.

The staff representative from the Monetary and Exchange Affairs Department (Mr. Marston), in response to questions from Directors, made the following statement:

> Mr. Cippà asked the staff to confirm that the targeted valuation of bank portfolios has been completed by end-March, 2002. In fact, the targeted assessment was completed with a two-week delay, as the auditors needed additional time to complete a number of detailed supplemental schedules required as part of the exercise. Therefore, the actual audit, including the supplemental schedules, was completed a few days before the current discussion, but this does not affect the material completion of the required action, as the delay was related to the supplemental schedules to the actual valuation.
>
> Looking ahead, the time line for the completion of the second audit, and the time line for the Banking Regulation and Supervision Agency (BRSA) to issue letters to the banks informing them of the capital that they need to raise, have not changed. There may be some revision of the time allowed for shareholders to raise capital, as the 15-days time allotted is likely to prove insufficient. Discussions between the BRSA and the banks may also require some extension in the time allocated, especially for banks that need to raise capital through public share issuances, although the extensions should not be longer than two weeks, or perhaps a month.

Mr. Kiekens confirmed the authorities' firm commitment to publish the staff report. Publications had been delayed in the past only as a result of the time required to negotiate the deletion of market sensitive information with the staff, as explained by the staff representative from PDR. The report that was currently under discussion should certainly be published as soon as possible.

Mr. Mirakhor observed that, while the somewhat pessimistic views of Directors on the prospects for growth in Turkey could be justified on the basis of the theoretical and quantitative analysis provided in the staff report, Directors should not underestimate the inventiveness, agility, and stamina that were at the heart of the Turkish private sector's dynamism. Any observer or analyst of the Turkish economic performance over the last 30 or

40 years would acknowledge the responsiveness of the private sector to incentive structures. While this sector had been subject to substantial shocks in the recent period, observers might be surprised by how rapidly the Turkish economy could recover once its two major problems in the fiscal and banking areas had been solved. For the time being, there should be no concern about the achievability of a sizable primary surplus and of a minimal growth rate.

Mr. Yagi asked the staff about the prospects for a turnaround in the current trend of weak bank credit to the private sector.

The staff representative from the European I Department (Mr. Kähkönen) confirmed that bank credit remained weak both as a result of supply and demand factors. On the demand side, sound companies did not currently need credit because they generated sufficient internal resources, whereas companies in a more delicate financial position were not yet in a condition to take new loans. The banking sector had obviously been subject to substantial shocks from the recent crises and the ongoing restructuring process, and it would take time for activity to resume. The pickup in credit demand would certainly take place at a faster pace if speedy progress could be made in the bank and corporate sector restructuring processes.

Mr. Chatah made the following statement:

> We welcome this opportunity to review Turkey's economic performance. Although it has been only two months since Board approval of the new stand-by arrangement, the magnitude and high visibility of Fund involvement in Turkey warrant close monitoring of developments and program implementation. We are pleased that the program is already yielding positive results. Policy credibility and confidence have clearly increased in recent weeks and months. Price pressures are declining, in turn, reducing inflationary expectations, and interest rates, which are critical elements of the stabilization strategy. Economic resilience has also generally strengthened, as reflected in improved financial indicators, a stronger exchange rate, and better prospects of debt rollover.
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> Notwithstanding this favorable performance, looking ahead, there are clearly a number of domestic sources of potential instability, including a still high rate of inflation, a fragile banking sector, and uncertainty about growth prospects. Regional uncertainties also add a considerable source of risk to the outlook. This only makes it all the more crucial to strongly adhere to the domestic policy agenda and try to build the needed political support for steady implementation of the economic program.
>
> The prior actions and all but one quantitative performance criteria for completion of the review have been met, and we can therefore support the proposed decision and offer only on a few selected comments on major policy issues. We will start however with some observations regarding the economy's growth prospects.

There is little doubt that Turkey's chronic financial instability has contributed not only to sharp volatility in growth performance but also to a trend decline in average growth over the last few decades. The charts on page 5 are quite telling. It is therefore natural, and doubly important, that priority be given to breaking the grip of inflation and inflationary expectations on the economy through steady implementation of the fiscal and monetary policies under the program. Achieving satisfactory growth is also in itself critical for the macroeconomic outcome. However, growth requires that private investment rebound from its recent slump and increase substantially relative to GNP over the medium term, as assumed under the program. This raises at least two issues, which the staff may wish to comment on:

To a large extent, the rebound and projected growth in private investment will be made possible by the resources released from the expected substantial decline in government dissaving. However, despite this expected decline in government dissaving, real interest rates are projected to continue to be very high for some time to come. In 2004 for example, real interest rates are assumed to remain around 20 percent. The implied average lending rate to the private sector will probably be even higher than that. On the face of it, such high real interest rates will make it rather difficult for the private sector to increase its investment activity as envisaged, unless other factors are expected to more than offset this seemingly prohibitive cost of credit, including increased resort to external credit. Moreover, the expected decline in dollarization on the deposit side will increase the effective cost of domestic borrowing. Staff clarification would be useful.

Turkey lags dramatically behind other emerging economies as a destination for foreign direct investment. While a rebound in medium term domestic private investment is assumed under the program, no similar rebound is projected for foreign direct investment. Factors determining foreign and domestic investment may not be identical, but they are not altogether different either. If foreign direct investment continues to be sluggish over the medium term, a question arises as to whether it is realistic to assume that domestic investors will behave very differently. If the investment environment is not conducive enough, not only will FDI remain very low, but also government savings may translate into outward investment and other capital flows. This underscores the importance of credible and steady progress in structural and institutional reforms to improve the investment environment.

Moving on to fiscal policy, we are pleased with the better than targeted improvements in public finances during 2001, despite the deep recession and the heightened difficulties. For 2002, the government should be commended for its determination to meet an even higher surplus. The downside risks to growth and hence revenue performance, which the authorities are well aware of, make strict adherence to the planned fiscal measures crucial. We also welcome the authorities' readiness to reinforce policies if need be, and we wonder whether staff or Mr. Kiekens can elaborate on the authorities specific contingency plans.

We are encouraged that price pressures and inflation expectations are on their way down. However, achieving a sustained victory over inflation and over long-entrenched inflation expectations remains a major challenge. The recent appreciation of the lira is a helpful development in this regard. Together with increased confidence and policy credibility, this should provide room over time to continue making gains against inflation, while allowing for some relaxation of monetary policy, thus reducing interest rates and improving debt dynamics. In the meantime, and while inflation targeting remains a desirable objective, it is important that sufficient progress in reducing the inertial forces in inflation before such targeting is formally adopted. Most important in this regard is the need to deal decisively with wage indexation. The chart on public sector wages on page 15 points clearly to a drift in real public sector wages over the past decade, which has proven costly both in fiscal and inflation terms.

The structural components of the program are rightly focused on rehabilitating the banking system and liberalizing state-dominated banks. While we welcome the measures taken to date, success in restructuring state banks and eventually privatizing the bigger loss-making ones will be critical for both stabilizing government debt and promoting private sector-led growth. We also look forward to the implementation of a sound strategy for corporate debt restructuring. As we and others have emphasized in the past, full transparency in this effort will be critical for building confidence and maintaining investor interests. At the same time, the restructuring strategy will need to be coupled by enhanced supervisory and regulatory frameworks as well as steps to reduce bureaucracy and red tape.

To conclude, even though Turkey's performance has not been very impressive in the past, the potential for an improvement is great. We wish the authorities continued success in the period ahead.

Mr. Brooke made the following statement:

In line with other Directors, I would like to start by commending the authorities for their strong implementation of the program, which has already had a positive impact.

Reflecting the positive developments in the last few months, we continue to believe that the structure of the program is appropriate. However, I have some sympathy for the concerns expressed by other Directors regarding the ambitious nature of growth assumptions under the program. While we certainly hope that these assumptions can be realized, we see plenty of downside risk and not enough upside potential when we look at the incentives and cost structures, and at their influences on the various aspects of demand. In particular, the high real interest rates, the higher-than-expected oil prices, the private sector retrenchment, as well as the ongoing difficulties in the corporate and banking sectors, point to downside risks for consumption and investment. Perhaps the only upside potential is that the recovery in Turkey's principal export markets could be stronger than currently assumed under the program. However, even this could be offset by regional political uncertainties that pose some downside for the outlook for tourism.

As highlighted by a number of other Directors, failure to achieve the growth target would no doubt make it harder to maintain the necessary political support to push through the painful structural reforms needed. Reflecting these concerns, I fully agree with Mr. Cippà that it would have been helpful to include a more detailed sensitivity analysis of debt sustainability in the Article IV report. This could also have been helpfully linked to a fuller discussion with the authorities about their contingency plans. In this regard, I welcome the comments from the staff representative from the European I Department that this has been a subject of discussion between the staff and the authorities.

More generally, these considerations lie at the heart of my authorities' desire to see a greater separation between Article IV surveillance and program reviews. Like Mr. Isleifsson, we see a need for a more objective and independent assessment in the context of the Article IV consultation than allowed under the current approach of combining Article IV and program reviews. While the staff report is certainly helpful, it is difficult to provide an objective view when program reviews and surveillance missions are performed jointly.

Although much less important in the grand scheme of arguments for greater independence of the surveillance function, it would be helpful if the staff could reexamine the format of Appendix V of the staff report which analysis Turkey's external financial vulnerabilities, as this appendix appears to be heavy in data but short on staff analysis and judgment. I would like to see some change in the balance of that appendix, which could serve a useful purpose in the report.

Given the significant risks highlighted, I agree with staff and other Directors that the program's success will depend crucially on the authorities' commitment and ability to keep the reform agenda on track. As we have seen previously, market confidence can rapidly evaporate if full implementation of the program with strong political support is not maintained.

Turning to fiscal policy, we continue to support the need for a significant fiscal effort. In this regard, the authorities are to be commended for the over achievement of fiscal targets thus far. However, we tend to agree with the concerns expressed in the report and by a number of Directors about the need to deliver a greater proportion of fiscal adjustment through expenditure reductions, rather than through measures to increase revenues. Similarly, we feel a greater effort should be made to simplify the tax system.

Given the problems in the banking sector, we have some concerns about the authorities' intentions to finance one of the new tax incentives with a larger-than-expected dividend from the Ziraat Bank, which is not a sustainable source of financing. We feel the credibility of the fiscal consolidation efforts would be enhanced not only by meeting the fiscal targets, but also by delivering them in the way that had been originally planned.

We strongly support the priority given by the authorities to social spending, and we welcome the enhancement of the social safety net, which will help offset the adverse impact of public sector retrenchment. It will be important that the costs and effectiveness of these measures are monitored carefully.

On the structural reform agenda, I welcome the fact that banking reforms appear to be progressing according to the agreed timetable, and we look forward to an update on the likely scale of these costs. The government's blanket deposit guarantee also has an influence on the contingent liabilities faced by the authorities, and I would be interested to hear the staff's views on the appropriate timing for its elimination.

It is equally important that the other structural benchmarks are also met in a timely manner, and we support the staff's call for determined steps to advance the privatization and corporate debt restructuring agendas. Greater commitment to these reforms will help maintain confidence in the program and improve the investment climate, as highlighted by Mr. Chatah.

On inflation targeting, we welcome the progress recently achieved in reducing inflationary expectations, although we are again a little disappointed that the authorities have postponed the introduction of formal inflation targeting despite the progress made. If the program remains on track, inflation looks likely to fall sharply over the course of the year. Given this background, we feel now is as good a time as any to switch to an inflation targeting framework, especially as such an announcement would help to break the inflation inertia and provide a downward guide for inflation expectations. We therefore urge the central bank to stick to the agreement to adopt formal inflation targeting framework by the middle of 2002, as noted in paragraph 24 of the staff report.

On safeguards assessments, given the unprecedented scale of this program and the concentration of outstanding Fund resources, we are pleased that the program incorporates new conditionality in this area to address the concerns raised by the staff on safeguards.

Finally, we welcome the measures that the Turkish authorities are taking to combat money laundering and financing of terrorism. We hope that the staff report will be published without delay, and we welcome Mr. Kiekens's remarks in that regard. I wish the authorities success in their extremely challenging reform agenda.

Ms. Lundsager made the following statement:

The strategy of front-loaded actions appears to have been well chosen, and we commend the authorities for the strong implementation date. These actions have helped generate a positive reaction by markets that has led to the improvement of key financial and macroeconomic variables, such as interest rates, the exchange rate, and inflation, even in the face of the sharp decline in GDP. Priors for Board reviews help keep the authorities on course with their program.

That said, continued success going forward will depend on "staying the course," especially the continuation of the government's unified support for the program and its full implementation. As the authorities acknowledge, they will need to respond to any unexpected developments promptly and forcefully, to sustain positive market sentiment and underpin the confidence that is needed for growth and investment.

Fiscal, Monetary, and Exchange Rate Policy

On fiscal issues, the authorities have achieved results, and we encourage building on those results by broadening the tax base while lowering marginal rates to help spur growth. In addition, improvements in tax administration are necessary, and we welcome the new benchmarks on this front. Structural changes in spending in the medium term are also needed to sustain the impressive fiscal adjustment. For this review, the authorities have identified the number of redundant positions in public enterprises and a timetable to eliminate one-third and two-thirds of these positions. The authorities should act expeditiously. We note that structural reforms will help generate private sector investment that would help absorb some of these workers.

On the monetary policy side, the authorities have made excellent progress in reining in inflation. The credibility of the central bank is growing, as seen in inflationary expectations starting to converge on the inflation targets. Like Messrs. Padoan and Brooke, monetary policy should continue to target inflation only, and we urge the transition to formal inflation targeting this year to occur as soon as possible. As noted by Messrs. Yagi, Bennett and others, further progress on reducing indexation is needed to support this move. We also appreciate the authorities' demonstrated commitment to a floating exchange rate. The float continues to play its intended role of providing flexibility and, recently, allowing the authorities to build reserves.

Banking and Other Structural Reform

Turning to structural issues, the implementation of the plan to recapitalize private banks is coming to a key juncture. The plan needs to be fully and forcefully implemented to create a banking sector that can fuel private sector-led growth, and we urge the authorities to: resist pressure from special interests for regulatory forbearance in loan classification or provisioning rules that would allow the banks to overstate their capital levels; and intervene decisively to minimize banks' further recapitalization needs and reduce expectations for future public support. Delaying action often leads to problems as we have seen elsewhere.

The authorities should consider steps to rationalize the taxation of the banking sector overall, in part because this would encourage bank owners to participate in the recapitalization of private banks. And, as Mr. Cippà points out, discriminatory taxation hinders the development of financial markets.

The World Bank is playing an active role in the banking sector, and the Bank Board is scheduled to discuss a $1.35 billion PFPSAL tomorrow. Could the Bank staff provide more information on what key policies are envisioned in this SAL and the timeframe for completion? We urge the staff to include even more details on this World Bank operation in future IMF program reviews as banking sector restructuring is critical to the success of Turkey's program. I also found that annex on technical assistance to be rather sketchy. It would be useful to have a more detailed exposition.

Corporate debt restructuring remains a key issue, and progress has been quite limited to date. We believe that the authorities should not—and need not—compromise bank recapitalization to accelerate corporate debt workouts. Both can be done. We urge the authorities to expedite the corporate restructuring process through other mechanisms, such as tougher bankruptcy provisions, which appear to be under consideration based on Messrs. Kiekens' and Çakir's statement.

We also urge the authorities to step up their privatization efforts, which would help improve the fiscal accounts, attract investment and improve productivity. The market appears to be improving. Announced delays in the privatization of the oil refinery Tüpraş create worries of a trend in the wrong direction. And, as noted in the last Board meeting, the authorities need to take steps to implement the recommendations of the Foreign Investment Advisory Service so as to improve the overall investment climate.

Other (Safeguards, PSI, TA)

Some final points: One, we are pleased that the safeguards assessment of the central bank has been completed and that additional work is covering the Treasury as fiscal agent. Like other Directors, we also support the inclusion of conditions to address weaknesses identified by the assessment of the central bank.

Two, on PSI issues, outflows of interbank credits have slowed significantly, suggesting that the voluntary approach based on strong policy action is having some success with Turkey returning to international markets with its recent issue of $1.5 billion in new eurobonds. Could the staff comment on whether these bonds include collective action clauses?

Three, we commend the Turkish authorities for their efforts to combat the financing of terrorism and money laundering. We urge the authorities to further develop their capabilities. Fund technical assistance can help in this and other areas.

Four, we note that a prior action for this review, namely the issuance of two communiqués on public debt, was not completed until April 12, in violation of our five-day rule. We reiterate that the rule exists to reduce the potential for misreporting and strongly suggest that the authorities be reminded of the importance of the five-day rule.

Mr. Bischofberger made the following statement:

We support the proposed decision and agree to the completion of the first review of the Stand-By Arrangement with Turkey. This program, for better or for worse, is clearly one of the flagship programs of the Fund. We are encouraged by the success of the program so far, especially in the fields of financial market access, exchange rate stabilization and inflation reduction. However, like other Directors we regret the fact that some prior actions and structural benchmarks have been fulfilled only belatedly and—if I interpret staff's statement of April 12 correctly—perhaps not yet to the extent as originally envisaged. Furthermore, we share staff's concerns that Turkey is not yet out of the woods and that the actual litmus test for the success of the program is still ahead.

I would like to thank Mr. Kähkönen and his team for the preparation for today's documents, which are comprehensive, well written and candid. I also thank Mr. Kiekens and Mr. Çakir for the helpful and comprehensive preliminary statement.

We broadly agree with staff's analysis and recommendations, and I will focus in my further remarks on the following points: the downside risks for the underlying growth assumption of 3 percent; monetary policy; and the reform commitment of the authorities.

On my first point, the downside risks for growth. One focal point of recent discussions on Turkey was the question, whether the assumed upswing in growth will be achievable. The latest available data, contained in the report, make the prospects appear rather gloomy. And even Mr. Kiekens's and Mr. Çakir's language in this respect is very cautious. Indeed, the last year was a bad year in terms of growth for Turkey. Yet, the troubling fact is, that the economic slide apparently has not come to an end. There were no signs for the start of a recovery in the last quarter of 2001. Like other Directors, I think that staff's concerns in this respect are fully justified, since the magnitude of the needed swing in economic activity has further increased. In addition, there are some worrisome developments which heighten the risks even more: Oil prices have risen; the steadily appreciating Turkish lira is likely to dampen export performance, and even though nominal interest rates have come down, credit demand is not expected to pick up significantly, due to remaining high real interest rates and an uncertain economic outlook. Putting all these developments together, the question arises whether a sensitivity analysis would not have been warranted in the connection with this review.

My second point is on monetary policy. We have repeatedly asked in the past, when the authorities are going to introduce a predictable and transparent monetary framework. For almost two years now, we have been told that the authorities think they will be capable of introducing a monetary framework in a couple of months. The new report continues this tradition. We strongly believe that the credibility of the monetary authorities depends on a transparent institutional setting with clear objectives. We are therefore disappointed that a timetable for installing such a framework is still missing. Interest rate cuts should only be contemplated if the authorities have firm indications about receding inflationary expectations. We hope that this condition was fulfilled before the recent cut.

My last point is on the reform commitment of the authorities. We share staff's view that an abating reform commitment could severely undermine the success of the program. However, we do not think it is accurate to describe this risk by saying that "the program's ambitious agenda could test the cohesion of the government" as staff did in paragraph 44 of the report. We would prefer to put it the other way around: A lack of cohesion of the government could derail the ambitious reform agenda of the program, which is necessary to achieve a sustainable economic position.. With the original wording we would run the risk of blaming the Fund for possible emerging problems within the government. I think the reform agenda is ambitious but necessary and manageable. The authorities have shown remarkable ownership developing this program and they should continue to show ownership during implementation.

Looking forward, I would like to encourage the authorities to stay their course and keep up the reform momentum. Staff has pointed to a couple of fields, where further progress is needed. Delays in the privatization of public enterprises are still a dark spot in the track record of the current program. In addition, the public sector is still overstaffed and further downsizing is needed. Furthermore, staff's remarks on deficiencies in the investment climate and the perceptions of corruption that plagued Turkey in the past, should be taken seriously. Direct investments are far below the potential level and staff does not expect any significant pick-up in the coming years, even against the background of an accelerated privatization and related privatization receipts. Could staff explain why not even the envisaged accelerated privatization is expected to have a significant impact on the current account, as table 4 seems to imply? On the corporate sector, I associate myself with comments made by Mr. Varela on the need of restructuring corporate debt. With regard to banking sector reform, I can broadly associate myself with Ms. Lundsager's remarks.

Finally, like other Directors including Mr. Brooke and Ms. Lundsager, we commend the authorities for their actions against money laundering and terrorism financing

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

Mr. Junguito made the following statement:

Since 1994, Turkey has experienced three severe recessions, two of them triggered by financial crises. In 1999, GDP declined 6.1 percent in real terms, and after a recovery of 6.3 percent the next year, GDP declined again in 2001 by 9.4 percent, its deepest recession since the 1940s. The output decline was accompanied by high inflation, which in 1999 end-of period was 68.8 percent and in 2001 68.5 percent. The severity of the crisis has contributed to a sharp increase in unemployment, which increased to 10.5 percent in the fourth quarter of 2001 from 5.5 percent in the third quarter of 2000. The poor economic performance was due to the structural rigidities, weak public finances, and low policy credibility. The new 2002-2004 program contemplates a strong structural reform agenda and a prudent fiscal and monetary policy to put the Turkish economy into the path of sustained economic growth. So far, the developments under the new program have been promising, and policy performance good, however, near term risks remain because growth prospects remain unclear, the concerns about military action in neighboring Iraq, and the need for an undivided support of the political coalition partners for the reforms in the months ahead.

The public sector primary balance has improved from a deficit of 2 percent of GDP in 1999 to a surplus of 5.9 percent in 2001. The program envisages a 6.5 percent of primary balance surplus for the next three years. This fiscal turn around was accomplished due to improvement in the public finances of the overall public sector and not only from the central government. The Law on Public Debt Management, which was approved by parliament in March, calls for organizational changes within the Treasury aimed at improving risk assessment and fostering closer coordination in managing the domestic and international debt portfolios. The Treasury intention is to continue pursuing a debt management strategy aimed at lowering interest rates and improving the term structure of its debt to reduce the rollover burden in the coming years. We commend the authorities for the impressive turn around in the fiscal position in the last two years, and hope that the authorities are able to maintain the fiscal stance as envisaged in the program.

Monetary policy after the February devaluation has been using base money targets to contain the surge in prices, and later this policy has been backed by a strong fiscal performance and structural reforms to reduce inflation. The inflation target for 2002 of 35 percent by end-year could be attained following the favorable inflation figures for February and March of 2.5 percent and 1.5 percent, respectively. A credible disinflation strategy, such as through the implementation of a nominal anchor based on formal inflation targeting could lower expectations and break inertia. In this respect, the CBT agreed with the staff that the case for an early introduction of inflation targets had strengthened and that the conditions should be in place by mid-2002. In the external front, the CBT was making use of the better-than-expected balance of payments position to build up foreign exchange reserves, however, the staff stressed that to keep money within the target path, the monetary impact of any reserve increase needed to be sterilized.

Structural conditionality has been an important feature of the program. The authorities have to be commended for the deep reforms introduced in the banking law to secure a fundamental improvement in the functioning of the banking system. The main areas covered by the program's structural conditionality are two fold: measures with an impact on macroeconomic stability, such as the banking reform, and measures that will improve medium-term growth prospects, which include measures to strengthen the tax policy and expenditure management, and steps to enhance the role of the private sector in the economy. A stable fiscal stance with solid primary balance superavits accompanied by a tight monetary policy and exchange rate stability, together with the wide array of structural reforms, will help the Turkish economy to register high economic growth in the coming years.

We would like to support the authorities' request for the completion of the first review under the Stand-By Arrangement. As the staff report indicated, after the September 11 events the Turkish authorities have made renewed effort to strengthen their economic program and have been successful in regaining credibility: Financial market conditions have improved as reflected in the fall of the bill rate and the appreciation of the nominal exchange, while the Treasury was able to top the Eurobond market. The reduction of inflation is also encouraging, while the policy performance has continued to be adequate. The authorities met all quantitative performance criteria for the first review and made progress in the policy and structural reform front.

We will now focus our comments on the near- and medium-term risks of the Turkish economy. Regarding the growth scenarios, we share the staff view that the near-term prospects remain unclear, while we find the medium-term annual GDP growth projection of 5 percent somewhat on the optimistic side. The significant decline in economic activity in 2001, the lack of clear signs of recovery during the second half of the year and the short-term output costs of disinflation, the reduced export growth stemming from recent appreciation of the real exchange rate, and low prospective private investment efforts indicate significant difficulties in meeting the 3 percent growth target established for 2002. On the other hand, establishing a growth scenario after 2003 at 5 percent annual rates in a country with high GDP volatility and low average growth rates in the recent past seems difficult to achieve. Staff, in the graph on page 5, informs us on the declining average annual GDP growth rates in the Turkish economy by five-year periods during the past decades? Could staff analyze the assumptions regarding savings and investment that support the projected growth scenario?

Our second concern regards debt sustainability. As an indicator of promising progress and growing confidence, staff argues that short-term concerns about the public debt rollover have abated, while in discussing the baseline medium-term scenario it estimates that net public debt would decline steadily from last year's 93 percent of GDP to below 60 percent by 2006. However, to achieve such results, if we understand it correctly, it is presumed that GDP growth can be sustained at 5 percent, that the fiscal effort will deliver sustained primary surpluses of 4.5 percent of GDP, and that private savings would be significantly strengthened. What would be the debt outlook if fiscal performance and growth were below the baseline scenarios? Could staff explain why a 60 percent debt/GDP ratio, even if achieved, would be sustainable? Could staff inform on the assumptions regarding the position of real interest rates in the debt sustainability scenarios? Is the maintenance of a high dependence on short-term public credit sustainable?

Mr. Callaghan made the following statement:

I agree with many of the comments in the statements of my two neighbors, Mr. Bennett and Mr. Cippà. But first, this is a joint Article IV and a program review, and the recent biennial review of surveillance did identify that there have been problems with joint program reviews and Article IV consultations. So, this issue is very fresh in all our memories. And, Mr. Isleifsson has already noted that the last Article IV consultation with Turkey was over two years ago—in December 1999. In the intervening period, there have been crises, a series of crises, Fund programs, and many, many reviews.

But we can ask the question: Was surveillance missing throughout this period? Mr. Brooke has already raised this issue about the role of surveillance and the separation of surveillance from program reviews.

We do not think a blanket institutional separation of program and surveillance processes is practical, but the suggestion has been raised that there are occasions when surveillance should be used to introduce a more objective assessment of economic developments in program countries. Why? Because such an objective assessment or fresh perspective, with a broader overview, may in fact help ensure we get the program right and it succeeds. When should we be looking to use the surveillance process to introduce such a broader perspective into the program country? It will always depend on the circumstances, but as Mr. Cippà stated in his statement, for Turkey we have an exceptional program in an exceptional situation requiring an exceptional effort by the authorities. Perhaps such exceptional programs are a good example when particular attention should be devoted to ensuring that the surveillance process is as effective as possible, including using the occasion to introduce a more objective perspective on developments, in order to help make sure that the program is right. And that is what I think Mr. Bennett has raised in his statement and even what other Directors are raising when they say they have doubts on the growth projections, doubts on the debt sustainability, which Mr. Junguito has already raised. I think we are asking the question, do we really think the program is going to work? It is not so much the question of implementation by the authorities, although that is always an issue, but assuming they do implement everything, will it work, will it work in the time period that we have envisaged?

Now, in raising these questions, we are in no way underestimating the strong progress the authorities have made in implementing a highly ambitious reform program. But, the basic question we should be asking ourselves now is do we think it is working?

I will only comment on a few issues raised in the paper. The objective of the program is to get the economy on a sustainable footing. This requires restoring economic growth. So, I have no pretense of originality, but like Mr. Junguito, I think I will focus on this question of growth. We want to get growth restored as quickly as possible. There have already been many comments that the growth assumptions appear optimistic and this was expressed very clearly in Mr. Bennett's statement. This has been a concern we have had in previous programs, and one with the reviews of the previous program, and also one which was raised when this program was approved last February, namely that the growth assumptions appeared too optimistic. Last February, the staff said that there was an upside risk to the 3 percent growth assumption for 2002. Now, they say notwithstanding declines in interest rates and the appreciation of the lira, the decline in the economy last year was larger than previously thought and the signs of a pickup in economic activity remain elusive.

It would be interesting to know what is the staff profile for growth over the course of 2002.

We all sincerely hope that we are just on the verge of the long awaited pickup in activity following the fall in interest rates and the improvement in financial conditions. These certainly were the preconditions that we all saw as being necessary for growth to resume. We hope that our concerns are misplaced and like Mr. Mirakhor has said, we all will be surprised about the extent of the recovery. But as it stands now, like Mr. Bennett, we do not think the staff projections for growth in 2002 are particularly convincing. In this regard, while Box 2 on Turkey's growth prospects is welcome, we think the analysis should have gone further, particularly given that this is an Article IV consultation.

According to the staff projections, stock building is to be the main contributor to growth in 2002. The justification for this in the staff report is that inventory adjustment was a major factor in past recoveries. This is perhaps a bit of a truism, for stock building will always play its part in any recovery, but the first requirement is to see a pickup or an expected pickup in the components of demand, namely investment and consumption. Little recovery in fixed investment is expected in 2002, a result of weak balance sheets and in essence a credit squeeze, which appears to be a consequence of the banking reforms. As Mr. Yagi has highlighted in his statement, bank credit to the private sector has been declining, and it is very hard to reconcile this with a sizable recovery in economic activity.

Related to this, Appendix IV raises the important question whether, given the presence of inflation inertia, the 35 percent inflation target can be reached without significant costs in terms of lost output. This is something Mr. Padoan has already raised.

As the paper notes, given the estimates of a sacrifice ratio from OECD countries, if these were taken literally, the reduction in inflation will not be achieved without further declines in output. The staff has already commented on this, but looking at the report, they note that by incorporating certain assumptions for the explanatory variables in the inflation equation, an outcome can be derived consistent with the 35 percent end-year inflation target. But, the issue is how realistic are the assumptions? Particularly for the exchange rate, oil price, and real wages. And I get the impression that the assumptions in the paper may now not be the ones now most likely, particularly with respect to oil prices. But, at a minimum, I do think that there seems to be some tension in achieving the growth and inflation targets. And it is relevant that in recent briefings Economy Minister Dervis has given he has indicated that it would be worth deferring growth for a few months in order to achieve the inflation target, to seize the opportunity to finally tackle Turkey's long-standing problem of persistently high inflation. He may be right, but what would lower than forecast growth mean for the other components of the program, in particular debt sustainability.

Any idea of an export-led recovery has gone, a consequence in part of the steady appreciation of the lira. When the program was approved in February, export volume growth in 2002 was projected to be 3.8 percent and import growth 7.7 percent. Now, export volumes are forecast to rise by only 1 percent, while import volumes are now forecast to increase by 9.2 percent, presumably the impact of higher projected domestic demand and the appreciation of the lira. The contraction in the contribution to growth from net exports has increased, and notwithstanding this larger contraction from net exports, the program sticks to the 3 percent growth projection, which means that the other components of demand, namely, domestic demands are now projected to be stronger than previously expected. Where? It must be private assumption. Private assumption is forecast to rise by 2.5 percent in 2002. Mr. Bennett has asked how can this be reconciled with the substantial reduction in public sector employment, high real interest rates, and tight credit conditions? Moreover, is there any sign of a recovery in consumer confidence? In addition, there is the question of the impact of higher oil prices, in both activity in the fiscal accounts, and the staff has already given some comments on the impact of the current rise in oil price, but it would be interesting to know what would be the impact if oil prices continued to rise.

In short, it is very hard to reconcile the growth projections which go to the heart of the success of the program. The longer growth appears to be elusive, the more this may lead to reduced vigor on the reform front. There are already moves to add further tax incentives in an effort to promote growth. The private sector is calling for more active measures to promote growth. In addition, recent comments from Mr. Dervis seem to suggest that the government may be thinking of deferring cuts to the private sector through extensive compulsory retirement and public service employment, saying that the program may need to be adjusted for the sake of the country's social and economic health. This is all related to a concern that we have raised before and one that Mr. Junguito has already raised, namely the feasibility of running 6 and a half percent primary budget surplus irrespective of the state of the economy.

Much more can be said about many aspects of the review, but I will just briefly mention two other areas. In Box 1 on labor market developments, one of the most pressing issues Turkey must confront is covered in the last line, namely "There remains considerable scope to reduce the role of indexation and wage contraction and the public sector should set the example in this regard." Mr. Chatah has already emphasized that breaking indexation is essential and the paper should have had much more coverage of wage developments and efforts to reduce backward indexation. What has been done to tackle wage indexation? All I could find is the paragraph reference in paragraph 1 of the MEFP, not in the Article IV report. In the timing of the move to inflation targeting, the authorities say they want a track record in reducing inflation so as to make an inflation targeting regime credible. Actually, adopting the framework with a commitment to adhere to it can help boost credibility and help reduce inflationary expectations. I saw more merit in the previous reasons that were offered for delaying the move to inflation targeting, namely technical reasons, not having confidence in the monetary policy instruments, or the relationships.

To conclude, it is a very challenging program with many risks and we wish the authorities well.

Mr. Segara made the following statement:

At the outset, I would like to thank the staff for their well written reports, and Mr. Kiekens and Mr. Çakir for their candid and helpful preliminary statement. We are encouraged that all relevant performance criteria and indicative targets for this review were observed, and we would like to commend the authorities for strong implementation of the program. Since we broadly concur with the staff assessment, I will be very brief.

On the fiscal front, we noted that fiscal laxity was one of the Turkish government's problem roots in the past. Therefore, budget discipline and maintaining the primary budget surpluses should be the main strategy for better fiscal performance and sustainability over the medium-term. In this respect, we commend the authorities' attainment in the public sector primary balance, from a deficit to a surplus of almost 6 percent of GNP in 2001. However, strengthening fiscal performance and its sustainability should be carried out on both revenue and expenditure sides. For this purpose, budgetary prioritization and efficiency of the public spending need to be enhanced. Therefore, decisive reforms in public sector employment are also warranted.

In the monetary and external sector, bringing the inflation down to more reasonable level remains the main challenge for the Turkish authorities. Despite the recent positive developments, the annualized inflation and short term interest rates at around 60 percent and 57 percent respectively are considered high. We are concerned that this condition, combined with appreciation of the Lira, may ruin Turkish competitiveness which eventually will worsen the condition of balance of payments. Meanwhile, the projected current account as well as capital account balance for 2002 as illustrated on Table 4 in the staff report are all deficits. That being the case, the financing needs required to fill the gap will be much larger. In addition, we also wonder whether businesses can run and generate positive net income in such high inflation and interest rates conditions. Staff comments in this matter are appreciated.

With regard to the structural reforms, we welcome the government's steps to reduce overstaffing in the public sector as a key to fiscal reforms. We noted that the authorities wish to avoid as many layoffs as possible, relying instead on voluntary retirement of workers. However, as Mr. Cippà has highlighted in his preliminary statement, we also wonder whether the staff have cost estimates and are aware of the net impact on the government's budget. In addition, given the low economic activity and the already high unemployment rate, we are concerned on the possible deterioration of the unemployment situation and its adverse implications to the program. To mitigate this risk, the authorities may need to stand ready with a greater social safety net budget.

Finally, given the authorities' strong commitment to the program implementation thus far, our chair would like to support the completion of the first review under the SBA for Turkey.

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

Mr. Alosaimi made the following statement:

Economic developments in Turkey are encouraging. The authorities' adherence to the agreed policies has paid off in lower inflation, firmer exchange rate, and higher reserves. Moreover, confidence strengthened as evidenced by the positive developments in the financial markets. That said, a convincing turnaround in growth performance is yet to emerge, and the situation remains subject to a number of near-term risks that are well detailed in the staff paper. To minimize those risks and put the economy on a sustainable growth path, the authorities need to persevere with their adjustment and reform efforts. Here, I will add a few comments.

The overachievement of the ambitious primary fiscal surplus target is reassuring. However, the authorities need to remain vigilant, especially if the economy does not recover as planned. Here, the importance of an early decline in interest rates cannot be overemphasized. Such a decline is essential for both public debt sustainability and growth. In this regard, I complement the authorities for the substantial progress on the inflation front, and welcome the interest rate cuts implemented so far. The substantial decline in inflation in March should facilitate further interest rate reductions as well as a move to inflation targeting. Indeed, despite the recent reductions, interest rates remain very high in real term.

Turning to the foreign exchange market, I am encouraged by the increased confidence as evidenced by the appreciation of the Lira and the increased accumulation of reserves. At the same time, I have some concerns regarding the fiscal cost of the associated sterilization. Staff comments on these costs and the possible impact on the fiscal picture will be appreciated. I would also like staff to elaborate more on the risk-return tradeoff of extending maturities at a time when interest rates are expected to decline substantially.

On the structural front, I welcome the considerable progress made in restructuring the banking sector. However, efforts are still needed, especially regarding private banks. To this end, I agree that rapid progress on corporate debt restructuring is essential. I also join staff in stressing the need to move ahead with privatization efforts. The improved market conditions provide a good opportunity at this time. Here, I note the authorities' efforts in this area and welcome the progress made in improving the business environment further.

With these remarks, I support the completion of the review along with the requested waiver and wish the authorities success.

Mr. Maino made the following statement:

Judged by recent economic performance indicators and the evolution of medium-term policy strategies adopted by the Turkish authorities, the reform program for 2002-2004 has been successfully reinvigorated. The progress presented at this First Review of the on going Stand-By Arrangement is encouraging. The proper design and implementation was timely strengthened and supported with the assistance of a World Bank's Country Assistance Strategy and builds upon the achievements from previous SBA. We know that there are no quick fixes for rebuilding confidence. In the context of a volatile and rising risk aversion that affects emerging economies, the authorities have taken decisive steps to take the country further away from the interventionist mode of the past—as staff pointed out—and to permanently strengthen fiscal and financial performance. This policy determination has helped the authorities to build up a good track record of policy implementation as the centerpiece of the improved and renewed confidence.

The upfront fiscal and structural measures implemented aimed at protecting the economy against future crises and continuing the reform agenda. Amid difficult external circumstances and within the deepest recession since 1945, the authorities are generating and consolidating promising results with respect to financial market conditions, public sector debt rollover and inflation. In these circumstances, we underscore the criticality of Fund's role in strengthening the medium-term prospects, which has been essential for consolidating the reform momentum and the shift in market sentiment. We are especially grateful for the decisive technical assistance provided by staff most especially after the serious financial crises of 2000-2001.Additionally, the full support of the coalition parties and the authorities' commitment and ownership of the strengthened reform program will be especially needed in the eventual case the economy does not take off soon from the present downturn.

However, in our view, the current situation remains fragile. In light of the persistence of structural problems and vulnerabilities and despite the assistance provided, the uncertain prospects of growth encompasses a declining domestic demand, limited export opportunities and a sharp deterioration in financing conditions, margins, and earnings experienced by the country's corporate sector. Given the high level of unhedged financial leverage, the corporate sector is reporting unprecedented losses and is still struggling to come to terms with a balance sheet adjustment. In spite of all the impressive steps taken by the government in restructuring the public sector, the private sector still appears behind the curve of global trends in corporate reengineering. The private sector should initiate its own restructuring process to improve competitiveness. Such a synchronization of macroeconomic policies and corporate reengineering could bring the boom-bust cycles to an end and raise the potential growth rate to a level that is consistent with the country's aspirations to join the European Union before the end of this decade. We would like to ask staff to comment briefly on the stage of the reform process.

The reversal of capital flows to emerging markets remains another key determinant of the cyclical volatility of Turkey's economic activity—and by extension, of all emerging markets. In this uncertain framework, the reconstitution of FDI to complement private domestic savings is deemed essential to spur total factor productivity and growth forecasts. Notwithstanding the successful placement of dollar and euro-denominated issues, global risk aversion has increased and Turkey is still not immune from the net negative flows affecting other emerging markets in the present context of uncertainty. Turkey's ability to reestablish access remains key to improving economic activity. The country needs to avert the adverse effects that cause a delay in the start of economic recovery and a further weakening of the current account. In this regard, we welcome the authorities' response aiming at a steadfast implementation of fiscal adjustment structural reforms and rapid progress in the fight against inflation. The structural reform program being enacted is helping to underpin this progress by focusing on the legal and regulatory frameworks for bank restructuring and privatization.

Banking Reform

The authorities' concerted strategy to strengthening the recapitalization of banks and to restructuring of the state banks in preparation for privatization is commendable. Further delays to address the problems in state banks and other undercapitalized private institutions can, however, prove to be extremely costly for Turkey. In light of the prevailing weak conditions in the banking sector, arising from inadequate prudential rules, lack of capital to meet regulatory requirements and the distortions associated with the operations of state banks, it is encouraging to note that the authorities have accelerated the reform process to consolidate the system by improving the regulatory environment and enforcing regulations. Additionally, the new conditions for completing the capital strengthening of financially weak private banks should help cushion against the emergence of systemic risk. The main challenge in the short-run involves completing the liquidation or privatization of all remaining state-owned and SDIF banks in trouble. In this regard, we welcome the authorities efforts, as revealed by Mr. Kiekens and Mr. Çakir´s, to resolving the situation of the four intervened banks still owned by the SDIF and to accelerate efforts towards restructuring creditor exposures. Staff comments would be welcomed, in particular, on whether explicit rules are being considered to limiting excessive risk taking and moral hazard. It would be important to complement the ongoing banking system reform with corporate debt restructuring.

Notwithstanding the reduction of the exposure of the banking system to interest rate risk, the high level of floating rates—at which shorter maturities are issued by the Treasury—still imposes a significant risk and drag on the economy. The elimination of overnight positions that exerts severe stress on interest rates should contribute to mitigate operational and loan losses in the near future and stabilize monetary policy.

Fiscal Policy

Despite the sharp decline in real GNP in 2001, the authorities maintained momentum to achieve an impressive turnaround in the fiscal position. Debt sustainability dynamics heavily hinges on interest rates convergence and on the attainment and consolidation of a primary surplus announced by the authorities. The Law on Public Debt Management recently enacted by Parliament couple with renewed confidence have, thus far, contributed to achieve lengthen average maturities and lower interest rates. In this sense, the effective implementation of the medium-term fiscal objectives, with respect to the balance target, becomes vital to redouble the ability of the government to rollover and sustain its debt. Nevertheless, we concur with staff on the need to provide balance to the composition of central government adjustment by considering the appropriateness of restraining expenditures and allowing the revenue ratio to be lowered to reduce supply-side distortions. Mr. Mirakhor is right to call the attention to the overstaffing in state-economic enterprises as a key challenge ahead. We welcome the establishment of an independent procurement agency to reinforce expenditure management and the three-year plan to reform the tax system to rationalize and harmonize taxes. In this sense, we appreciate staff's enlightening analysis in box 4 on the consequences arising from a complex system of differential taxes. We note that the tax burden in the economy is still jeopardizing economic recovery. Perhaps staff could further comment on the authorities ideas for tax cuts.

Monetary and Exchange Rate Policy

We welcome the technical work undertaken, regarding the improvement in inflation forecasting and other initiatives taken to develop a forward and futures markets. Such a framework will underpin a true floating exchange regime and will provide greater scope for monetary policy flexibility. Nevertheless, the monetary instruments and preconditions for introducing a full-fledged inflation targeting are not yet present. Fiscal dominance, backward indexation, the lack of proper hedge instruments and the permeability of the current institutional framework suggest that the conditions are not yet in place to ensure the credibility of a new permanent nominal anchor for the program. In this sense, we consider appropriate to build up reserves as a way of bolstering confidence and to provide a cushion against contingent risk. However, we remained concerned about the announced interventions in exchange markets to smooth excessive fluctuations. They need to be carefully explained to avoid market misinterpretation regarding a possible targeting of the exchange rate.

In closing, the Turkish authorities demonstrated, at a critical stage of the reform process, a strong commitment by not only adhering to ambitious goals, but most especially by meeting the more than ten prior actions and all quantitative performance criteria relevant for this review. Once again, we support the Proposed Decision for the approval of the First Review of the Stand-By Arrangement.

Mr. Kpetigo made the following statement:

Despite the difficult financial circumstances, the Turkish authorities have made significant progress under the Fund-supported program, which has started to show positive results. Fiscal consolidation became more apparent in early 2001, banking sector restructuring has continued to move ahead, pension reform and the privatization process have gained momentum. Overall, we agree with the staff that Turkey is taking decisive steps, moving from the past policies toward more market-based policies that bode well for a stronger performance in the future. We commend the authorities for these positive achievements, and since we are in broad agreement with the staff and most of the previous speakers, we will limit ourselves to a few comments.

On the fiscal front, the achievement of the primary surplus target is critical in view of the debt situation. We encourage the authorities to implement as quickly as possible the new law on public debt management. The introduction of cost-saving measures in the social security administration is welcome. However, to ensure a sustainable improvement in the fiscal sector, efforts to improve expenditure management, streamline tax policy and strengthen revenue administration must be steadfastly pursued. We support the authorities' decision to reduce the investment expenditure in order to compensate for the shortfall in revenue collection and attain the primary surplus target.

On monetary policy, the floating rate system was widely accepted by market participants, giving the CBT greater flexibility to implement monetary policy. As recent inflation developments have been encouraging, we encourage the authorities to work toward laying the conditions for formal inflation targeting.

As regards structural reforms, we commend the authorities for introducing some radical reforms that will improve the banking system. The actions conducted by the authorities to deepen structural reforms and bring the banking sector operating rules up to international standards are welcome. The authorities recently decided to put in place a scheme to allow the use of public money under strict conditions to assist banks in their recapitalization efforts. Although the move is understandable, we urge the authorities to be prudent and make sure that the related conditions are observed.

Finally, we commend the authorities for the progress made in implementing the recommendations of the 2000 fiscal Report on Observance of Standards and Codes (ROSC). We support the proposed decision.

Mr. Rustomjee made the following statement:

I join other colleagues in commending the Turkish authorities on the progress made with the stabilization of their economy under the current Fund supported Stand-By Arrangement (SBA). And like others I would like to thank Mr. Kiekens and Mr. Cakir for their detailed and very informative Buff statement. It is particularly heartening to note that Turkey complied with all the applicable performance criteria and indicative targets despite the deepening recession during the period under review. I have therefore no hesitation in joining other Directors in supporting the completion of the first review under the current SBA. Since I am in broad agreement with the overall thrust of the staff paper I will limit my comments to a few issues for emphasis.

Fiscal Policy

I commend the authorities for implementing sound policies under the program, particularly in meeting the highly ambitious targeted public sector primary surplus for 2001. Performance has been admirable. These results were achieved notwithstanding the lower revenue collections with the authorities successfully managing to implement cost-saving measures inter alia in social security administration. We concur with the staff appraisal that further measures may be needed by the authorities to ensure that the projected primary surplus is met for the duration of the program and we very much welcome the authorities' commitment to take offsetting measures, whenever needed. Furthermore, we would urge the authorities to try to avoid measures that could increase the complexity of the current tax framework with additional incentives. Such measures could in our view, create loopholes in the tax system that could be difficult to monitor and manage. We also concur with the views expressed by Mr. Kelkar and Mr. Jayatissa, and other colleagues that debt management policies need to be strengthened to ensure that the country's debt position remains manageable.

Monetary Policy

We commend the authorities for their efforts to implement monetary policy, and the associated lowering of inflation and of inflationary expectations, which have been the result of this effort. While we concur with the view expressed by staff that inflation targeting could provide an additional anchor in lowering inflationary expectations, we would express some caution on the proposed timing of such a policy framework. Such a framework would in our view need a much lower level of inflation than that currently prevailing, as well as a longer track record by the authorities in reducing and maintaining low inflation. We would urge the authorities to first ensure that the conditions necessary to reasonably assure success of such a framework are in place before proceeding with formal adoption of inflation targeting. In this respect we very much concur with the approach suggested by Mr. Kelkar and Mr. Jayatissa, and the assessment of Mr.Wei as to the elements that it would be useful to have in place before implementing the formal framework for inflation targeting. At the same time, even stronger attention to structural reforms will in our view contribute significantly to reducing inflation inertia.

Structural Reforms

Turkey has made sound progress with structural reforms, particularly with banking sector reform, but further efforts are needed to complement the already sound progress in the area of macroeconomic stabilization. These could include lower wage indexation in the public sector and further impetus to the privatization program. Indeed, the privatization drive, in our view, needs to be expedited, and we concur with the staff that the authorities should exploit the more favorable market conditions to achieve this end. On issues of overstaffing in the public enterprise sector, we agree however with Mr. Mirakhor that in view of the already existing high levels of unemployment, the issue of overstaffing in the sector needs to be handled with sensitivity. Here the use of voluntary early retirement will, we imagine, be an important element of the overall strategy. Improved performance by the current state economic enterprises, which could emanate from their privatization, could in our view contribute to higher overall growth performance in Turkey. Furthermore, improved governance of these enterprises before their privatization, as well as improving the investment environment by the Turkish authorities, could also contribute to enhanced growth performance.

Financial Sector Policies

We commend the authorities for their remarkable implementation track-record in restructuring state banks, including the preparation for future privatization of some of these. We welcome the launching in January 2002 of the voluntary market-based framework for restructuring corporate debt (The "Istanbul" approach). We are also pleased to note the use of asset management companies for medium-term and welcome the fact that debt restructuring for small borrowers has already commenced.

We wish the authorities every success with future endeavors.

Mr. Yakusha made the following statement:

Like other Directors, I welcome the recent positive developments and support the proposed decision. Lower than expected growth now seems to be the major risk to the medium term outlook and to the success of the program. Of course, we see some other risks, but we have discussed these in detail at our previous meeting, barely two months ago. I will limit myself to a few observations with regard to the program and the staff report.

First, I was glad to note that, due to the better than expected balance of payments position, reserves already exceed the program floor by US$1.6 billion. In addition, I note that the Treasury has been quite successful in tapping the markets for new financing. Under these circumstances, I do not think Turkey really needs to draw this or at least the next tranche and I would urge the authorities to consider treating these tranches as precautionary. By not drawing, I believe the authorities would send a very strong signal to the markets. I also think it would be the appropriate thing to do in what is a very large and heavily frontloaded program. Of course, the balance of the undrawn tranches would remain available to Turkey. Perhaps staff could also discuss this with the authorities at the time of the next review.

I support Mr. Cippà's and other Directors' remarks with regard to the state economic enterprises and conditionality. At first, I thought a 'prior action for review' to be stronger conditionality than a regular performance criterion. Now I am not so sure anymore. In my view, the prior action with regard to the SEEs has not been fully met. Had this been a performance criterion, the Board would have been asked to grant a waiver. Now we are just asked to conclude the review. If this is how 'prior actions for review' work in this particular case, I fully agree with Mr. Cippà that performance criteria are preferable for the remainder of the program.

Now I turn to the staff paper. Unlike some previous speakers, I find the balance between Art. IV and UFR appropriate to the extent it is possible. The Article IV part does take a step back and places Turkey's current program in a longer-term perspective. The document includes some—albeit a bit limited—alternative scenarios, an account of the discussions with the authorities, a box on competitiveness and a vulnerability report. Of course, things could always be better. For instance, the vulnerability report is largely descriptive and backward-looking, but this is probably unavoidable given market sensitivity. On the whole, I would like to compliment staff on an excellent report.

I was glad to note that the report—at last—mentions the Turkish trade blockade of Armenia. Unfortunately, the blockade is only mentioned, and not discussed. I understand that the macroeconomic consequences for Turkey are negligible. However, at our discussion on surveillance last week, we concluded—I quote from the final concluding remarks—"Coverage of trade policies is critical …. as well as in countries whose trade policies have global or regional implications—for example, where trade policies in the major industrial countries affect market access for developing countries, or where trade policies have a significant impact on countries in that region." This is definitely the case for Armenia: some EU-experts estimate the loss caused by the blockade at 25 percent of Armenian GDP. I also understand that the Turkish authorities claim their blockade is for security reasons. Of course, I am not asking staff to assess the security situation, but I do believe they could ask the authorities to explain their concerns in more detail, as otherwise all countries could claim trade restrictions or tariffs are in place because of some unspecified concerns.

Finally, I welcome the Turkish consent to the publication of the paper. I would welcome its timely publication even more.

Mr. Palei made the following statement:

I would like to thank the staff for an informative report and Mr. Kiekens and Mr. Çakir for their preliminary statement, which presented a useful summary of Turkey's achievements. At this stage of the discussion I will comment only on a few issues: on the risks of premature introduction of inflation targeting; on the need to address backward price and wage indexation; on banking sector; and Istanbul approach.

In response to Mr. Bennet's preliminary statement, I note that, in our view, the catalytic approach in case of Turkey was and remains warranted, and doubt that comprehensive debt restructuring would have been accompanied by the progress in many program areas to the extent we see it now. The case of Turkey is an excellent illustration of the complexities involved in evaluation of debt sustainability and in determination of the point in time when the situation becomes unsustainable. It also points to the trade-off between the clarity of rules for provision of official financing and the possible depth of reforms in each particular country case.

We have doubts about the urgency to formally introduce inflation targeting. Although the central bank is now independent and committed to anti-inflationary stance, its policy can hardly be aggressive. In Turkey, inflation is driven mainly by expectations of market participants, which certainly are influenced by the credibility of the central bank and by the extent of its commitment to reduction of inflation. However, these expectations may also be easily subjected to unfavorable shocks, which are outside of the central bank's control. It seems to be rather odd to point to existing vulnerabilities of the Turkish economy to confidence shocks and, at the same time, push the authorities toward making promises they may not be able to fulfill. The authorities' ability to be aggressive in their monetary policy is severely constrained by the large level of public debt and its sensitivity to real interest rates. The most unfortunate outcome would be to announce a formal introduction of inflation targeting and to compromise the framework in a relatively short period of time. Under the circumstances, it seems to be appropriate to continue with the current approach, i.e. to strengthen gradually the elements of future inflation targeting. More transparency in the conduct of monetary policy is a preferable way to make the goals of the central bank clear and its anti-inflationary stance credible.

The staff has prepared an interesting appendix IV titled "Understanding the Inflation Expectations in Turkey". Essentially, this short paper considers the balance between the two sources of inflation inertia: on the one hand, the structural rigidities in prices and wages and, on the other, the degree to which inflation expectations are sticky. It appears that in the report for today's discussion the staff, maybe unintentionally, shifts the emphasis on the management of inflation expectations, while less attention is paid to backward indexation. Previously, the programs with the Fund put an emphasis on wage and price rigidities and deeply entrenched backward indexation. There was insufficient progress on this front as the authorities faced political resistance, and the Social and Economic Council failed to deliver on repeated promises. The staff should not underestimate the role of structural price and wage rigidities as a source of inflation inertia and should not accept weakening in the authorities' resolve to address them in the state sector.

The staff appropriately pays close attention to the side effects of ongoing reforms in the banking sector. The existence of significant distortions in taxation of money market and cumbersome reserve and liquidity requirements are a matter of concern. As the staff note, the money and foreign exchange markets, in Turkey, are shallow now, and this fact creates serious impediments to financial transmission mechanism. We call on the authorities to deal with these issues earlier rather than later.

The authorities and the staff agree that the success of the clean up in the banking sector, as well as growth recovery in general, depend on the health of the corporate sector. We call for the acceleration of the Istanbul approach to restructuring of the corporate debt, and ask the staff to report on this progress in the future reviews in sufficient details.

With these remarks, we support the proposed decision and wish the authorities success in facing challenges ahead.

The staff representative from the European I Department (Mr. Kähkönen), in response to comments from Directors on the downside risks to growth, observed that there was also upside potential in the projections. As noted by Messrs. Chatah and Bischofberger, foreign direct investment (FDI) and medium-term real interest rate assumptions under the program were conservative. The debt dynamics would significantly improve if FDI flows and interest rates turned out to be more favorable than assumed, as this would reduce Turkey's debt-creating financing needs.

On medium-term projections more generally, the staff representative noted that the debt sensitivity analysis included in the staff report prepared at the time of Turkey's request for an SBA had shown that public debt would be sustainable over the medium-term, and prospects had improved further since the approval of the arrangement. As mentioned in the previous Board discussion, a fiscal primary surplus of 5 percent could be sufficient to achieve medium-term debt sustainability, and the 6.5 target under the program had been designed to accommodate possible downside risks including lower-than-projected growth. Therefore, substantially lower-than-projected growth in 2002 would not prevent the debt-to-GDP ratio from falling sharply. Over the medium-term, while the debt scenario would be less favorable with growth rates substantially lower than the projected 5 percent rate, the debt-to-GDP ratio would stabilize even with GDP growth as low as 3 percent.

Regarding comments on the appendix on external vulnerability, the staff representative observed that the appendix was based on materials prepared for the monthly discussions on vulnerability held between the authorities and the Fund's resident office in Turkey. The staff would work on the format of the appendix as requested by Messrs. Brooke and Yakusha.

On Mr. Alosaimi's comments on the possible risks associated with extending maturities in a context of lower interest rates, the staff representative considered that, while this could result in higher fiscal costs, it would also help reduce vulnerabilities associated with the central bank's large short-term exposures. Moreover, in the context of Turkey's segmented financial markets, lengthened maturities would help develop the yield curve, which should serve as a benchmark for market pricing.

The staff representative from the Policy Development and Review Department (Mr. Ebrill), in response to Ms. Lundsager's question on collective action clauses, noted that the three bond issuances in 2002 had been U.S. dollar bonds under New York law, and that they had not included collective action clauses.

The staff representative from the Monetary and Exchange Affairs Department (Mr. Marston), in response to Mr. Brooke's question on the appropriate timing for the removal of the blanket guarantee on bank deposits, observed that the staff's advice to the authorities in light of the current recapitalization scheme had been that the guarantee should be removed when the system had regained some measure of soundness. The staff estimated that this would be the case in early 2003.

The staff representative from the World Bank (Ms. Frigenti) informed Directors that the Bank's Board would discuss the day after the current Board discussion a Public Sector and Financial Sector Adjustment Loan (PFPSAL) for Turkey, which would be the second loan provided by the Bank to support the structural adjustment program. The first PFPSAL had been approved in July 2001 for an amount of $1.1 billion. The second PFPSAL had been originally designed to be a single tranche operation, but had been subsequently restructured in a three tranches operation of $450 million each. The tentative schedule under the new loan envisaged the three tranches to be released in May, July, and October of 2002, subject to the achievement of satisfactory progress under the program. The program was expected to be completed by December 2002.

The key activities to be implemented in the financial sector, the staff representative from the World Bank continued, included further modernization of the regulatory framework for banking activity, the institutional development of bank regulation and supervision agency and further progress in problem bank resolution and state bank restructuring and privatization.

In the public sector, the staff representative from the World Bank concluded, the loan would support a fiscal policies in support of sustainable fiscal adjustment, the implementation of public expenditure management reform—including concrete improvements to the framework for budget planning and execution, financial accountability and public liability management—the government's strategy to strengthen public sector governance—including adoption and implementation of a nation anticorruption strategy—and initial steps toward civil service reform.

Mr. Kiekens made the following concluding remarks:

> This was an in-depth discussion of Turkey's economic situation and policies. It was greatly facilitated by a set of excellent analyses prepared by the staff.
>
> As is appropriate for an Article IV consultation, the Directors took some distance from day-to-day implementation and the almost constant reviews of Turkey's stand-by arrangement. Many Directors made insightful

comments on the long-term economic trends during past decades, and analyzed many distortions and unsustainable financial developments that have plagued the Turkish economy. They pointed to periods when growth, but also volatility, was high, and to a trend of declining average growth rates.

A good part of our discussion focused on what will be required to achieve and maintain high growth in the years ahead. I was particularly struck by the pertinent observations of Mr. Padoan and Mr. Chatah on the need for capital accumulation, employment growth, and above all, enhanced productivity in the Turkish economy.

Mr. Junguito was perfectly in his role of Executive Director when he asked the staff to clarify the macroeconomic assumptions, such as the savings and investment rates and capital inflows from abroad, that underlie the 5 percent real growth projected for coming years. Not that Mr. Junguito doubts that such a trend is possible. Indeed, he agrees with the Board's Dean, Mr. Mirakhor, had said earlier in the meeting about his strong belief in the resilience of the Turkish economy. And I can confirm that during the eight years I have taken part in these Board meetings, Mr. Mirakhor has always been a keen observer making accurate analyses of the Turkish economy. Even so, it is very helpful to spell out the many assumptions that justify high growth projections, because they provide important signposts for policymakers.

There was a clear consensus in the Board on what is required for sustainable high growth in Turkey: foremost it includes fiscal sustainability, low inflation, financial sector soundness, and an improved investor climate to foster capital accumulation and increased productivity through domestic and foreign direct investment.

The growth objective and the requirements for fiscal, financial, and structural policies are all interrelated. Low inflation cannot be achieved as long as there is fiscal dominance. Fiscal sustainability is not possible without sound banking, and will be greatly facilitated by high and sustained growth, which in turn cannot be achieved without low inflation and a strong banking system to intermediate between savings and investment.

Much of the discussion concerned the tradeoffs which there will occur this year and next, between inflation reduction and growth and between fiscal consolidation and growth.

Mr. Padoan pointed to the risk that inflation reduction into single digits may cost more than is now anticipated. Indeed, the nominal interest rates may decline more slowly than inflation, pushing real interest rates higher and slowing growth. Indeed, that is the scenario that the staff projected in Table 9 of its January 2002 paper on Turkey's SBA request. While real interest rates were estimated to have been 21 percent on average in 2001, the staff projected them as moving upwards to 29 percent on average this year, before gradually falling to 26 percent in 2003, 20 percent in 2004, and still lower in later years. These are obviously guarded projections, leaving room to cover adverse developments. Making cautious projections increases the likelihood that Turkey's economic performance will exceed the program. This may well already be happening. In the last two months, the drop in inflation and inflationary expectations makes achieving the end-year target of 35 percent inflation more and more likely. At the same time, the nominal interest rate on TL bonds is now 58 percent, more than 10 percent below the average nominal interest rate projected for the year 2002 as whole. Real interest rates may therefore be substantially lower than assumed by the program. When considering the balance of risk surrounding the 3.5 percent real output growth projected for 2002, these positive interest rate developments largely offset the downside risks mentioned by several Directors. This is also the view expressed by the staff in its reply to Directors.

I believe that the drop in inflation in line with the program target will have very positive effects on consumer and investor confidence. Even in the short term, the trade-off between inflation and growth should be positive. In any case, there is no doubt that this will be true in the long term. Low inflation is a critical condition for lowering real financing costs and stimulating savings and investments. If anything, the history of high Turkish inflation in recent decades shows how it interfered with the deepening of financial intermediation, and thereby reduced savings, investment, and growth.

I would like to make a few comments on some of Director's specific policy recommendations.

I took good note that the U.S., German, and British Directors insisted that the central bank should introduce formal inflation targeting as soon as possible. But I also noted that the Directors for China, India, English-speaking Africa, and Russia, among others, agreed that inflation targeting should not be introduced until all the conditions for a successful launch are in place. Mr. Palei praised the central bank for increasing the transparency of monetary policy. This, he said, is a important step toward effective inflation targeting.

Further on inflation reduction, Mr. Isleifsson and Mr. Chatah, among others, recalled the critical role of wage formation. This was useful. I would like to confirm to the Board that the central bank is strongly committed to introducing inflation targeting. The bank is organizing a seminar with experts from six other central banks who have experience with this strategy. The central bank is confident that with the lengthening of maturities, the emergence of long-interest rates will greatly contribute to the successful launching of inflation targeting.

On bank reform, I particularly took note of the general call to respect the time frame for bank recapitalization and the warning of the U.S. Director, supported by the German Director, not to tolerate regulatory forbearance. They did accept the idea of fiscal incentives for participating in bank recapitalization.

On fiscal policy, several Directors recommended that the authorities increase the efficiency of expenditures, simplify the tax system, broaden the tax base, and lower tax rates.

A clarification for Ms. Lundsager may help. She rightly reminded the Board how useful the many prior actions of the Turkish government have been in signaling to the Turkish public and the international markets Turkey's ownership of the program and the determination to implement it fully. At the same time, she urged the authorities to comply with our rule that prior actions should be completed five full working days before a Board discussion. That is correct indeed. However, let me share with you what the Turkish Minister of State for Economy told me when I was traveling with him to Turkey two weeks ago, namely that the Parliament was then considering the 22nd major law required under the program. We all know what efforts it takes to prepare these laws and have them discussed and accepted in Parliament. But there is more. In Turkey, laws enacted by Parliament must also be approved by the president of the republic. This is not always a foregone conclusion, and also takes time to accomplish. I would like to remind Directors that if they look at Annex B of the staff report, they will see a list of 109 structural policy actions, all to be implemented fully and on schedule. The Turkish program is not one of the Fund's streamlined programs. It is a great accomplishment for the Turkish government to have implemented so well the intended structural policies and to have adhered so well to their conditionality. But I do apologize for not having been able to fully respect the five-day rule I just mentioned for one or another prior action.

The most important advice provided by Directors is their strong encouragement for the government to continue implementing the program fully and on time, with unwavering determination. As Mr. Brooke eloquently said, the reform agenda should be kept on track, because market confidence can rapidly evaporate if political commitment is wavering. Mr. Brooke, I assure you that I will quote you exactly to my authorities in Ankara.

In closing, it is a pleasure to express gratitude, on behalf of my authorities, for the very professional work of the staff, and for the constant interest and support you have shown, Madam Chairman, even though you have many more demanding tasks to deal with all at the same time. In addition, I wish to thank my colleagues for their insightful comments and advice, and above all for their decision to complete this review, and to continue the Fund's confidence in the Turkish authorities.

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

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the Turkish authorities' decisive efforts to address the problems of the past and implement an ambitious economic reform program to lay the basis for sustainable growth. In the past, financial indiscipline and structural weaknesses had prevented Turkey from realizing its economic potential, and had created an environment of highly volatile growth and inflation spanning several decades. These problems had their roots in fiscal laxity, deficiencies in governance, lack of a nominal anchor, and inefficiencies and nontransparencies in the public sector, and were evident in barriers to private sector development and a banking sector damaged by the two recent crises. Directors welcomed the Turkish authorities' progress in addressing these weaknesses and reduce the vulnerability of the economy to shocks through their bold three-year program. They noted that the program represents a further decisive step away from the interventionist policies of the past, and that it would lay the groundwork for a stronger performance in the future.

In this regard, Directors commended the authorities for maintaining the positive momentum of macroeconomic adjustment and structural reform established in response to the events of September 11. Macroeconomic policies have remained prudent; and the government has continued to press ahead with structural reform, notably with respect to the identification of public sector staffing redundancies and the adoption of the legislative basis for improved public debt management. The authorities' efforts have been rewarded by a substantial decline in interest rates, a strong balance of payments position with an associated appreciation of the Turkish lira, and a drop in inflation and in inflation expectations.

Directors noted that, while these positive results should help lay the basis for sustainable growth, there are downside risks. In particular, they emphasized that the strength and timing of the recovery in output are uncertain, and that financial markets have remained alert to the possibility of further shocks. Directors expressed concern that prolonged slow economic growth would have an adverse impact on Turkey's debt sustainability. To boost growth, they emphasized the importance of structural reforms to raise private investment and productivity and to lower real interest rates. Directors stressed that successful program implementation in the months ahead will require the undivided support of the government coalition.

Directors stressed that, although fiscal developments remain on track, strict budget implementation must continue in order to ensure a sustainable debt position. While commending the authorities' commitment to the target of a public sector primary surplus of 6.5 percent of GNP in 2002, they stressed the need to remain mindful of possible downside risks, and urged the authorities to stand ready to take further offsetting measures to safeguard the primary surplus target and maintain external debt sustainability.

Directors noted that, to be sustainable, the achievement of the overall budget targets will need to be underpinned by decisive reforms. They were encouraged by the government's efforts to improve expenditure management, streamline tax policy, and strengthen revenue administration. On the tax side, they stressed the importance of simplifying the tax code. On the expenditure side, they noted the importance of moving expeditiously with the much-needed downsizing of the state economic enterprises and civil service reform.

Directors noted the increasing scope for monetary policy to promote disinflation and enhance confidence. In this regard, Directors were encouraged by the recent decline in current and expected inflation. The introduction of inflation targeting will further anchor inflation expectations. While a number of Directors noted that, with strong efforts by the CBT and the government, the preconditions for introducing formal inflation targeting could be in place by midyear, some other Directors considered that a longer track record on disinflation would be needed for such a framework to be credible. Regarding reserve management, they urged the CBT to continue to make use of the better-than-expected balance of payments developments to build up foreign exchange reserves, which should further improve confidence, and welcomed the authorities' recent move to pre-announced foreign exchange purchase auctions. They urged further development of the money and foreign exchange markets to help ensure a smoother functioning of the floating exchange rate regime, and welcomed the authorities' plans to lower distortionary taxes and reform the system of reserve requirements. They also stressed the need to closely monitor Turkey's external competitiveness in light of the recent appreciation of the Turkish lira.

Directors welcomed the progress in banking sector reform, including the implementation of the bank recapitalization plan, but called for further rapid movement on corporate debt restructuring. Moving forward, Directors stressed the importance of preserving the integrity and transparency of the bank recapitalization process, and of sticking to its announced timetable. They also underlined the need to maintain the independence of Turkey's regulatory institutions. Directors urged the authorities to accelerate privatization now that market conditions are more favorable, noting that inefficiencies in state economic enterprises are a core factor behind Turkey's disappointing growth performance in the last decade. Similarly, Directors urged the government to be forceful in demonstrating its commitment to dealing with deficiencies in the investment environment and promoting transparency and efficiency of public administration both at the central and local levels. Directors welcomed the measures taken to combat money laundering and the financing of terrorism.

Directors commended recent moves to improve transparency and data provision. Although some deficiencies remain in fiscal statistics, they welcomed the recent extensive improvements in fiscal transparency.

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

Key UFR-related Issues and Concerns

Directors welcomed the fact that all applicable quantitative performance criteria and indicative targets for the first review under the SBA were observed. In light of the risks to the program, however, Directors stressed the importance of unwavering implementation of the program, with the undivided support of the government, in the months ahead.

Directors stressed in particular the importance of faster progress in the structural areas. They welcomed the progress in banking sector reform, but observed that progress in corporate debt restructuring has been slow. They urged the authorities to ensure that the framework for such restructuring (the "Istanbul Approach") is made operational without delay. Directors urged the authorities to proceed expeditiously in carrying out the program's agenda for privatizing key infrastructure companies now that market conditions are more favorable. Similarly, they urged the government to be forceful in demonstrating its commitment to dealing with deficiencies in the investment environment and the perceptions of corruption that have plagued Turkey in the past. Efforts in these areas should help Turkey to attract foreign direct investment, particularly over the medium term.

Directors welcomed the authorities' commitment to act upon the recommendations of the Fund safeguards assessment.

The Executive Board took the following decision:

1. Turkey has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Turkey (EBS/02/8, Sup. 3, 02/05/02) to review program implementation.

2. The letter of the Minister of State for Economic Affairs and the Governor of the Central Bank of Turkey (CBT) dated April 3, 2002 (the "Letter"), shall be attached to the Stand-By Arrangement for Turkey, and the letter of the Minister of State for Economic Affairs and the Governor of the Central Bank of Turkey dated January 18, 2002 shall be read as supplemented and modified by the letter dated April 3, 2002.

3. Accordingly, the following provisions shall be added after paragraph 3(b)(iii) of the Stand-By Arrangement:

"(iv) after July 15, 2002, if Turkey has not issued the report by the CBT's external auditors on the consistency between program data reported to the Fund (specifically base money, net international reserves, and net domestic assets) and the audited CBT financial statements, as set out in Annex B and further specified in paragraph 19 of the Letter, or

(v) after December 31, 2002, if Turkey has not reorganized the internal audit function of the CBT by adopting a new charter and by formulating an implementation plan, as set out in Annex B and further specified in paragraph 19 of the letter; or"

4. The Fund decides that the first review contemplated in paragraph 3(c) of the Stand-By Arrangement for Turkey is completed and that Turkey may make purchases up to a cumulative amount of SDR 8,194.00 million until April 20, 2002, and thereafter in accordance with the arrangement, notwithstanding the non-availability of information necessary to assess the observance of the end-March 2002 performance criterion on the cumulative primary balance of the consolidated government sector set out in paragraph 3(a)(i) of the arrangement, on the condition that the information provided by Turkey on the implementation of the measures specified as prior actions for the first review in Annex B attached to the letter dated April 3, 2002 is accurate, and on the further condition that with respect to the purchases that are subject to the end-March 2002 performance criterion on the cumulative primary balance of the consolidated government sector, Turkey has accurately represented that such information is unavailable and that the information provided by Turkey on the performance under this criterion for January 31, 2002 is accurate. (EBS/02/61, 4/4/02)

Decision No. 12723-(02/41), adopted
April 15, 2002

4. EXECUTIVE DIRECTOR

Length: 25 minutes

The Acting Chairman bade farewell to Mr. Quarles on the completion of his service as Executive Director for the United States.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/02/40 (4/12/02) and EBM/02/41 (4/15/02).

5. BURKINA FASO—ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—COMPLETION POINT

Pursuant to paragraph 4 of the decision on the completion point adopted in principle on April 9, 2002 attached hereto, the Fund decides that the World Bank has concluded that Burkina Faso has reached the completion point under the enhanced HIPC Initiative. Accordingly, paragraphs 1, 2 and 3 of the decision on the completion point adopted in principle on April 9, 2002 shall become effective on the date of this decision. (EBS/02/55, Sup. 1, 4/11/02)

Decision No. 12724-(02/41), adopted
April 12, 2002

6. CAPE VERDE—POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT

Pursuant to paragraph 4 of the decision dated April 4, 2002, the Fund decides that the World Bank has concluded that the Interim Poverty Reduction Strategy Paper submitted by Cape Verde provides a sound basis for the development of a fully participatory PRSP and for Bank concessional financial assistance. Accordingly, Paragraph 3 of the decision dated April 4, 2002 set forth in EBS/02/54 (3/22/02), shall become effective on the date of this decision. (EBS/02/54, Sup. 2, 4/10/02)

Decision No. 12725-(02/41), adopted
April 10, 2002

7. JORDAN—EXTENDED ARRANGEMENT—EXTENSION

1. Jordan has requested an extension of the Extended Arrangement set forth in EBS/99/51 (Sup. 3, 4/28/99) to May 31, 2002.

2. The Fund decides that the period of the Extended Arrangement for Jordan shall be extended to May 31, 2002. Accordingly, paragraph 1 of the Extended Arrangement shall be amended by replacing “For a period of three years from April 15, 1999” by “For the period from April 15, 1999 to May 31, 2002.” (EBS/02/62, 4/4/02)

Decision No. 12726-(02/41), adopted
April 11, 2002

8. MANAGING DIRECTOR—ACCEPTANCE OF AWARD

The Executive Directors approves the acceptance by the Managing Director of the Baden-Württemberg Medal of Distinguished Service by the state of Baden-Württemberg.

Adopted April 10, 2002

9. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 02/7 are approved.

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Director, and by Assistants to Executive Director as set forth in EBAM/02/46 (4/8/02), EBAM/02/47 (4/9/02), EBAM/02/30, Supplement 2 (4/10/02), and EBAM/02/50 (4/11/02) is approved.

APPROVAL: July 26, 2002

SHAILENDRA J. ANJARIA
Secretary