October 31, 2001
Approval: 11/7/01

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 01/81

10:00 a.m., August 1, 2001

Contents

Executive Board Attendance

S. Fischer, Acting Chairman
E. Aninat, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
S.M. Al-Turki	A.S. Alosaimi
	D. Ondo Mañe
	K. Kpetigo, Temporary
T.A. Bernes	P. Charleton
	J.A. Chelsky, Temporary
	P.R. Fenton, Temporary
M.J. Callaghan	D.C. Guinigundo
	M. di Maio, Temporary
	S. Antic, Temporary
	R. von Kleist
	C.-P. Schollmeier, Temporary
	J.N. Santos, Temporary
	F. Manno, Temporary
D.I. Djojosobroto	H.E. Phang, Temporary
	N. Jadhav, Temporary
	J. Jonáš, Temporary
	C. Josz, Temporary
	J. Sipko, Temporary
	Å. Törnqvist
	A. Fidjestøl, Temporary
	M. Lundsager
	J.M. Abbott, Temporary
	P.A. Brukoff, Temporary
	E.S. Weisman, Temporary
	G. Bauche
	B. Couillault, Temporary
	I. Mateos y Lago, Temporary
	S. Le Gal, Temporary
A. Mirakhor	J.K. Kwakye, Temporary
	S. Vtyurina, Temporary
	E. González-Sánchez, Temporary
S. Pickford	N. Joicey, Temporary
	M. Walsh, Temporary
	H. Mori, Temporary
C.D.R. Rustomjee	J.A.K. Munthali, Temporary
A.S. Shaalan	
Wei Benhua	Jin Qi
	Liu, F., Temporary
	Y.G. Yakusha
	A. Kapteyn, Temporary
K. Yagi	
	O.A. Hendrick, Temporary

A.S. Linde, Acting Secretary
A. Mountford, Acting Secretary
J. Prust, Acting Secretary
T. Davidson, Assistant, S. Djumena, Assistant
J. Puig, Assistant and O. Vongthieres, Assistant

Also Present

ECB: G. Grisse, B. Kisselevsky. IBRD: F. Kilby, Africa Region Office; W. Mako, East Asia and Pacific Region Office; C. Visconti, Latin America and Caribbean Region Office. African Department: G.E. Gondwe, Director; P.A. Acquah, Deputy Director; R. Bhaynani, D. Guillaume, M. Katz, A. Kyei, E. Lueth, M. Nowak, A. Tahari. Asia and Pacific Department: Y. Horiguchi, Director; A. Chopra, R. Elson, P.F. Gruenwald, K.H. Kang, H. Liang, H. Ma, A. Richards. European I Department: M.C. Deppler, V. Cerra, S. Coorey, R. Hagemann, J. Soikkeli. External Relations Department: R. Brauning, M. Fouda, A. Gaviria, Y. Kamata. Fiscal Affairs Department: R. Gillingham. Legal Department: K. Christopherson, R.B. Leckow. Monetary and Exchange Affairs Department: P. Hayward, M. Karasulu, J. Scarlata. Policy Development and Review Department: L.P. Ebrill, A. Gilmore, M. Hadjimichael, G.R. Kincaid,J. Ramirez. Secretary's Department: L. Hubloue, P. Ramlogan, T. Turner-Huggins. Statistics Department: C.S. Carson, Director. Western Hemisphere Department: J. Di Tata, E. Fernandez, F. Frantischek, A.M. Jul, G. Lopetegui, G. Yadav. Office of the Managing Director: R. Sahay. Advisors to Executive Directors: M.A. Ahmed, E. Azoulay, S.A. Bakhache, A. Baukol, M.P. Bhatta, W.-D. Cho, S.S. Farid, O.E. Garner, J. Mafararikwa, A.D. Marinescu, M.F. Melhem, Y. Patel, K. Sakr, M. Yépez. Assistants to Executive Directors: S. Alcaide, S. Bonomo, T. Elkjaer, T. Hadded, F. Haupt, H.-H. Jang, B. Kelmanson, T. Komatsuzaki, T. Koranchelian, D.H. Kranen, T.-M. Kudiwu, I. Kupča P. Lathouly, Y. Lissovolik, R. Maino, M.L. Nikitin, L. Ocampos, K.S. Oo, P.R.D. Prasad, A. Rambarran, Y. Saito, B. Siegenthaler, J. Sigurgeirsson, T. Skurzewski, D.B. Waluyo, N. Watanabe, Xu J., I. Zakharchenkov.

1. KOREA—POST-PROGRAM MONITORING

The Executive Directors considered a staff paper on the post-program monitoring discussions for Korea (EBS/01/111, 7/5/01).

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

> This statement provides additional information that has become available since the staff report (EBS/01/111) was circulated to the Board on July 5, 2001. This information does not change the thrust of the staff appraisal.
>
> Recent indicators suggest a further weakening in growth prospects for 2001. Industrial production fell by 2 percent (m/m) in June, after being flat in May. Non-semiconductor output growth was positive, but the downturn in the ICT sector depressed overall industrial production. Wholesale and retail sales and construction orders also contracted in June, while July data show that the downward trend of exports has become more pronounced. Although leading indicators and indices of consumer and business confidence have been encouraging and unemployment remained low at 3.6 percent (seasonally adjusted) in June, on balance the indicators point toward a downward revision of the staff's 2001 growth projection of 3½ percent. The envisaged revision will be finalized after the mid-August release of preliminary estimates of real GDP for Q2, 2001, and will hence be reflected in the published version of the WEO.
>
> At its July meeting, the Bank of Korea cut the target for the overnight call rate by 25 basis points to 4¾ percent, its second cut in the current cycle. Statements made by the Bank of Korea's (BOK) Governor that economic growth is slowing more rapidly than expected, and that demand side pressures on prices are weak, have been interpreted as a shift in the bias of policy towards further possible easing, a shift that the staff views as appropriate.
>
> The planned easing of fiscal policy is yet to be realized. The consolidated central government budget recorded a surplus of 2½ percent of projected annual GDP in the first five months of 2001. Although expenditure authorizations were front-loaded, the pace of actual spending has followed the typical seasonal pattern of relatively low expenditure in the first half of the year. The supplementary budget presented to the National Assembly in June would increase the 2001 fiscal deficit target from 0.2 percent of GDP to nearly 1 percent of GDP. In view of the slowing economy, it is important that the stimulus envisaged in the supplementary budget is achieved.
>
> Despite recent tension in some other emerging markets, Korean financial markets have been relatively calm. The sovereign spread for Korea

(measured by the EMBI+) has edged up only 12 basis points to 163 basis points since end-June, and the exchange rate has remained fairly stable. Although the broad stock market index has fallen by 10 percent in July, net portfolio outflows (through July 25) were a modest US$350 million, about the same level as the previous month. Foreign reserves have increased to $97 billion, up $3 billion from the figure mentioned in the staff report, primarily because of the off-market purchase by the BOK of the receipts from an international sale of shares in Korea Telecom; the government's stake in the company has now been reduced to 40 percent.

Recent asset quality and bank profitability data point to continued improvements. As of end-March 2001, financial institutions' impaired loans declined to 9½ percent of total loans, down 1 percentage point from the previous quarter. Separately, the government recently started talks with DB Capital Partners (DBC), a private-equity arm of Deutsche Bank, for the sale of Seoul Bank. Reports suggest that DBC is interested in buying a minimum of 30 percent, and may go for 51 percent depending on the consortium they put together, with pro-rata representation on the bank's board.

Corporate balance sheets, however, remain weak. The Financial Supervisory Service has released the results of an analysis of the combined financial statements (CFS) of 13 chaebol in 2000. The CFS showed higher debt-equity ratios than conventional consolidated statements. Further, the CFS showed that the average debt-equity ratio for these large groups (nonfinancial affiliates only) rose to 251 percent in 2000 from 224 percent a year earlier, highlighting slow progress in deleveraging and improving profitability.

On July 18, the National Assembly passed a "Corporate Restructuring Promotion Law" that aims to facilitate market-driven corporate restructuring by providing a legal framework for the out-of-court workout process. Key features of the new law include requiring the establishment of a creditor committee when a company shows initial signs of financial distress and assigning higher priority to new lending under workout programs. About 1,000 companies are expected to be subject to the new law. As noted in the staff report, although the new law could strengthen somewhat the workout process, it also runs the risk of eroding the benefit of flexibility associated with voluntary out-of-court negotiations. It is encouraging, therefore, that the authorities have recently launched a task force to review existing bankruptcy laws and prepare a framework by the end of this year for a strengthened and unified code.

Mr. Callaghan and Mr. Cho submitted the following statement:

At the Article IV discussion in January this year, Korea stressed that, notwithstanding the enormous progress that had been made in restructuring the economy, now was not the time for complacency. That view is held as firmly today as it was then. While there are signs of a resurgence in consumer confidence and a rebound in domestic capital markets, the external environment has deteriorated with a weaker world economy and turmoil in a number of emerging markets. External developments do not in any sense pose a threat to the Korean economy, but they have made the environment in which the ongoing reform efforts are being pursued more difficult as well as increasing the urgency of the task.

The Korean authorities know what reforms are still required, particularly in terms of addressing the continuing weakness in the corporate and financial sectors, and they are committed to this task. However, while the tendency may be to focus on the unfinished reform agenda, it is important to recall what has been achieved and remember how far Korea has come since the 1997 crisis. It is because of the substantial strengthening of economic structures in recent years and the maintenance of sound macroeconomic policies that the instability in the world economy is unlikely to destabilize the Korean economy.

Our Korean authorities would like to record their support and appreciation for the post-program monitoring (PPM) discussions, and particularly for the very competent and professional mission led by Mr. Chopra. The mission's candid and informed views have assisted the authorities in assessing the status of various reforms, particularly in the area of financial and corporate restructuring. They would also like to extend a special thanks to Mr. Fischer, who has played an instrumental role not only during the program but in continuing to remind the Korean public of the importance of continued reforms during his recent visit to Korea. This is a message the authorities fully endorse and have acted upon.

We broadly agree with the staff report, although our authorities do have a slightly different view on some points. The areas which we believe need to be clarified are covered below, but first we will make a few comments on the economic situation and policy settings.

Economic Situation and Policy

The authorities' assessment on the recent performance of the economy does not differ greatly from staff's. Domestic demand is still sluggish although the authorities are somewhat more confident of its rising trend than staff. As outlined in the staff's Statement, domestic sales and construction orders fell in the month of June, but there has been a steady increase during the first half of the year. Domestic sales in the wholesale and retail sectors rose 4.3 percent in the second quarter (quarter on quarter) compared with 2.5 percent during the first quarter. More broadly, the service sector, which accounts for 51.1 percent of GDP, grew 7.9 percent in May, up from a 6.3 percent increase in April. Industrial production fell in June but it was affected by the downturn of the semiconductor sector. The non-ICT sector recorded positive growth during June. The unemployment rate has reached its lowest level for three years and while inflation has risen due to increases in public sector charges and the depreciation in the currency, the rate of increase has slowed and there is no evidence of demand putting pressure on prices. The weaker global economy has had a negative influence on the real sector and this is not expected to improve in the short term.

Against this background, the authorities recently announced a revised forecast for this year, with forecast growth lowered by one percentage point to 4–5 percent and indications that it may be 4 percent if the expected rebound in the U.S. economy is delayed.

Timely Change in Macroeconomic Policy-Mix

Macroeconomic policy is providing the required stimulus to domestic activity, which is one of the factors underpinning the authorities' slightly more optimistic forecast for growth. The authorities have recently announced their intention to accommodate a consolidated fiscal deficit of up to 1 percent of GDP in 2001 compared with the former deficit target of 0.1 percent of GDP. A supplementary budget of W5.1 trillion (0.9 percent of GDP) was recently submitted to the National Assembly.

While there was a relatively slow start in the actual disbursement of budgeted spending at the beginning of the year, the staff's advice on the necessity of front-loading fiscal expenditure has been well-heeded. The allocation of fiscal revenue for disbursement during the first half of this year was 53 percent compared with 48 percent during the corresponding period last year. Efforts towards accelerating spending will be further strengthened during the second half of 2001 with the passage of the supplementary budget. To this end, the budget authorities are monitoring progress with disbursements by the operating ministries and provincial governments.

In addition, state-run enterprises, such as the Korea Power Corporation, will expand capital investment as well as spending ahead of schedule. Several government funds will also be encouraged to expand their portfolio investment to include real estate and to sponsor infrastructure projects. In terms of the more fundamental reform of budget practices foreshadowed by the staff, the authorities are currently considering the best way to address the recommendations of the recent FAD technical assistance report based on this year's experience.

Monetary policy settings are also being adjusted in response to the easing in both activity and inflationary pressures. In his 5 July announcement of the 25 bps reduction in interest rates, which is in addition to the 25 bps reduction in February, the Governor of the Bank of Korea made it clear that the monetary authorities would remain flexible in terms of responding to the needs of the economy. The banking sector has responded to the easing in monetary policy by reducing deposit and lending rates. Interest cuts, together with mild currency depreciation during the first half of the year, have contributed to the relatively good performance of the capital markets and this should have a positive impact on activity in due course.

Continued Progress in Corporate and Financial Restructuring

A major reason for the authorities' positive outlook for the economy is their commitment to corporate and financial restructuring. In fact, the authorities believe that substantial progress in this area has made a major contribution to the rebound in the bond and equity markets during the first half of this year. There has been substantial progress with a few high profile cases of corporate restructuring, particularly HEC, Hynix and Daewoo Motors. This is well-summarized in the staff report (Box 1 and paragraph 6). These cases are by no means complete, but the course of restructuring is well in train and has been clearly outlined to markets. The government has encouraged financial creditors to expedite restructuring of their client firms with the rigorous enforcement of prudential regulations; financial institutions are recognizing loan-losses, both through higher provisioning and marked-to-market accounting, resulting in a more aggressive approach to the restructuring of their debtor firms.

The restructuring in the financial sector is gaining speed. The Woori Financial Holding Company was launched, consolidating five insolvent institutions and injecting additional capital. In addition, the merger of two leading commercial banks, Kookmin and Korea Housing Bank, is due to be completed by November this year and a new CEO for the merged bank has already been appointed. Reprivatization of the nationalized banks will take place during the latter half of next year but this schedule will not preclude an earlier privatization of individual banks if their situation is appropriate. In particular, Seoul Bank is negotiating with a private equity fund for equity participation.

With the application of the asset-backed securitization (ABS) scheme and the corporate restructuring vehicle (CRV), nonperforming loans (NPLs) in the banking sector have been substantially reduced; the NPL ratio as of end-March 2001 is 7.6 percent, almost halved from the 13.6 percent as of end-1999. The NPL ratio is expected to be comfortably below 5 percent by the end of this year, which is the authorities' target.

The authorities are determined to speed up the process of corporate and financial restructuring, given the political schedule ahead and recent turmoil in some emerging markets. They are aiming for the restructuring process to reach the point where there can be no turning back before the elections next year (the provincial election will be held in June and the presidential election in December). They also believe that, in order to withstand any future crises, it will be important to convince international investors that Korea is not just another emerging market. They note clearly that, during the recent turmoil, the spread in the risk premium among emerging economies widened.

Industrial Relations Have Improved

The improvement in industrial relations is another reason why the authorities believe the outlook for the Korean economy is positive. Although industrial unrest has hindered reform efforts in the past, employees in individual firms are now coming to terms with the fact that restructuring is inevitable. For example, Daewoo Motors workers, who used to lead the militant trade unions and strongly objected to foreign ownership, have agreed to a significant cut in the company’s labor force and to the sale of Daewoo Motors to GM. The reluctance of workers to participate in the call for a general strike is another example of the improvement in industrial relations. The authorities’ tougher stance against any illegal labor activities is registering with the labor sector. This improved industrial relations environment will contribute to speedier progress with corporate and financial restructuring.

Issues Requiring Clarification:

Corporate Debts

While the debts of the corporate sector are still large, we should not overlook the reduction in corporate leveraging compared with the pre-crisis period. We would also add that loan-loss recognition by financial creditors is reflected in the balance sheets of companies only with a time lag. This means that the debt-equity ratio may not necessarily reflect the actual financial status of companies, especially if they are in the middle of the corporate restructuring process.

For example, most of the former Daewoo affiliated companies have agreed to a debt rescheduling with their creditors, and creditors have already recognized loan losses in their books. Nonetheless, Daewoo companies currently record their debts at face value in their books, although they do not have to pay interest. The scheduled write-off or debt-equity conversion will take place only at the time of corporate restructuring, either through M&A or breaking-up for the establishment of a new corporation. If we exclude Daewoo companies, the debt-equity ratio as of end-2000 improves substantially to 167.4 percent compared with the 210.6 percent quoted in the staff paper.

The interest coverage ratio is a very important concept to judge the soundness of a company and it is increasingly being adopted by financial institutions for their credit analysis. In fact, it is now one of the central elements of loan classification under the forward-looking criteria scheme. It is true that quite a few Korean firms do not earn sufficient operating profits to cover their interest payments. But we should not forget that the average interest coverage ratio of manufacturing companies has improved substantially, from 0.96 in 1999 to 1.57 in 2000. Furthermore, an interest coverage ratio of less than one does not necessarily mean that a company is facing insolvency, although it obviously is a cause for concern. Hasty judgments on the solvency of a company based on the existing interest coverage ratio alone should be avoided.

Stress Tests in the Financial Sector

The staff's analysis in Box 2 is informative and stimulating. We certainly hope this kind of exercise will be undertaken with much more depth and sophistication during the FSAP, which Korea formally requested a month ago. The most important implication of this exercise is that the Korean financial sector would survive even under what could be considered the worst-case scenario.

That said, our authorities are concerned that the market may over-react to this exercise by believing that this illustrative scenario reflects the IMF staff's view of the likely outcome. In a still volatile market situation like Korea, care needs to be taken that the assumptions used in any scenario-building exercise do not become self-fulfilling. For this reason, the authorities strongly believe that the underlying assumptions used in the staff's scenario II are too extreme.

KDB Bond Underwriting Scheme: A Victim of Its Own Success?

When the Korea introduced the KDB bond underwriting scheme, they stressed that this was an emergency arrangement to prevent the breakdown of the bond market. At the last Article IV consultation discussion, Directors recognized the justification for the scheme but recommended that it should be transitory so as to avoid distortions and that it be limited to viable firms with temporary financing problems.

Since the launch of the scheme, the bond market has rebounded quite remarkably. During the first half of the year, net bond issuance amounted to W10.7 trillion. Companies with a credit rating of BBB-, which formerly could not access the market on their own, are now comfortably able to raise finance on the market. Even companies with a speculative rating can obtain market access, although their volume of raisings is much smaller. The amount of bonds purchased by KDB through the underwriting scheme was also much smaller than expected; during the first half of the year, KDB expected to purchase W2.1 trillion worth of bonds but it only purchased W1.4 trillion.

However, to some extent the KDB has been a victim of its own success. The scheme was designed for KDB to resell 70 percent of its purchased bonds through the mechanism of Primary-CBO. But with regained access to the bond market, most firms were increasingly reluctant to use the P-CBO scheme, given that it is far more costly than direct bond issuance. This means that KDB has had increasing difficulty in finding other bonds to be bundled with its already purchased bonds to create a pool of bond collateral. So far, KDB has had to keep W0.4 trillion more bonds than expected because of the delay in the execution of the P-CBO scheme. The parking period of bonds has been a little longer than expected, although this is a small price compared with the fact that the objective of the scheme, namely the avoidance of any disruption in the bond market, has clearly been achieved. Furthermore, as noted in the staff report, the KDB underwriting scheme will be terminated by end-2001.

Weak Affiliates of the Hyundai Group

As noted in Box 1 of the staff report, creditors of Hyundai Engineering and Construction (HEC) and Hynix semiconductors (former Hyundai Electronics) agreed to a debt rescheduling package. Hynix has also successfully undertaken an international equity issue. In this process, the government-sponsored credit guarantee company took part as one of the creditors, by providing a guarantee to bonds repurchased by investment trust companies (ITCs). This is a part of the loss-sharing program among creditors, since the bonds being rolled over were already guaranteed by the credit guarantee company.

Even with the progress in the restructuring of these two firms, our authorities clearly recognize that many risks remain. The increasing downturn in the semiconductor sector poses considerable uncertainties to the prospects for Hynix. But this is a market risk not limited to Hynix alone.

The authorities have the same view as the staff regarding the need to consider a contingency plan, should the current rescue plans not succeed. The creditors of the two companies have reviewed all the available options. We are certain that they know only too well what the remaining options are if the current restructuring efforts are unsuccessful. As the Managing Director has indicated in other contexts, however, it is one thing to work on contingency plans, and another to publicly discuss them.

Conflicts of Interests Due to Government Ownership of Banks?

Our authorities place a high priority on the reprivatization of the banks that were acquired as a result of the crisis. Reprivatization is an important step back to normalcy. But even during the inevitable period of government ownership, a clear distinction has been made between ownership and management. Professional managers have been selected as the CEOs of the banks and the government has avoided any involvement in the management of the banks, particularly decisions with respect to corporate restructuring.

As for bank supervision, Korea has not been slow in introducing advanced practices. The forward-looking criteria (FLC) approach, implemented from early 2000, is a notable example. Under the FLC, it is expected that banks may differ in terms of the classification of loans to the same company, because situations differ, the collateral supporting a loan may differ, and ultimately banks have to use their own discretion. Loan classifications are, however, subject to regular inspection by the supervisory agencies, who are determined to review cases as often as necessary. Furthermore, in order to avoid inappropriate differences in loan classification among creditor banks, the self-regulatory Coordination Council for Loan Classification was formulated in January this year.

Certainly, there were times when the authorities exercised forbearance in order to encourage banks to play a leading role with corporate restructuring. Work-out loans, for example, were allowed to be provisioned less than 20 percent in 1999. But this kind of forbearance has been withdrawn. The supervisory bodies are determined to ensure there is no conflict of interest in terms of the government's responsibility for prudential oversight of the banking sector and its position as a major shareholder in a number of banks.

The Merger between FSC and FSS?

The government sought advice from the staff about what to do with the Financial Supervisory Commission (FSC), a decision-making body without enforcement power, and the Financial Supervisory Service (FSS), a much bigger implementation organization but not a government agency. (The status of FSS is very peculiar not least because it has its own labor union.) The government also commissioned an independent panel to advise on the future structure of the FSC and FSS. While the government has taken note of the recommendations of the staff and others, it has decided to maintain the status quo so as not to hinder the major supervisory task the bodies currently face. Given the political schedule ahead, the government considers that now is not the time to tackle another sensitive reform issue.

Strengthening the Insolvency System

There is a full consensus among economic ministries on the urgency of strengthening insolvency laws, particularly by providing senior creditors with more leverage over junior creditors in the court-supervised resolution process. But as the staff has rightly indicated, the procedure for streamlining the bankruptcy laws is not an easy task.

In these circumstances, new legislation was passed by the National Assembly with bipartisan support, which provides a legal basis for the existing out-of-court work-out procedure and includes such features as automatic stay and higher priority for new lending. While the staff expressed concern that the strengthening of the out-of-court procedures may have lessened the need for improved court-supervised insolvency procedures, it has in fact had the opposite effect. The Ministry of Justice, which has the authority to amend bankruptcy laws, launched an expert task force team in mid-June to review the existing bankruptcy procedure and to prepare the framework for a unified code by the end of this year. We believe that successful progress in amending the bankruptcy laws could see the new legislation covering out-of-court settlements facing a natural demise before its scheduled termination in five years.

Pressure by Chaebol to Relax the Current Regulatory Regime?

Korea's commitment to chaebol reform has not changed. This reform should, however, involve market participants being encouraged to play a more aggressive role in monitoring firms' performance. Easier M&A, strengthening financial supervision, creating a market for distressed loans and the enforcement of more stringent rules on corporate governance are all related aspects of chaebol reforms.

The government did relax the application of the cross-equity limit. But this does not represent a setback in chaebol reform. The relaxation only involves the timetable for compliance; the 25 percent ceiling remains. In fact, "relaxation" is an inappropriate description of what has occurred. The delay in compliance was allowed to facilitate exceptional cases of corporate restructuring. The regulation had been a stumbling block for corporate restructuring in a number of cases. For example, a company that wants to break up into more than two firms can find itself subject to the cross-equity limit regulation. Given that a substantial corporate restructuring remains, the authorities agreed to a two-year extension for compliance of the cross-equity limit.

Another exception related to companies that newly joined the list of the 30 largest conglomerates. It was felt necessary to place the newcomers on an equal footing to those already on the list; existing members had already been given one year to prepare and it was decided also to provide new members with a one-year preparation period.

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

Korea achieved a remarkable turnaround since the 1997 crisis, and has improved the resilience of the economy through the implementation of a set of key reform measures. Substantial challenges remain ahead, however. The economic slowdown that set in during in the fourth quarter of 2000 is still ongoing and may continue into next year in view of the external fragile environment, coupled with the sluggish domestic corporate restructuring that would have an adverse impact on a weak financial sector—a problem that Korea shares with a number of Asian countries. Should the Japanese Yen weaken further, and if continued weakness in the semiconductor sector persists, the corporate sector and with it the financial sector would be impacted very negatively. We therefore urge the Korean authorities to step up their reform efforts in these two interrelated areas, including the acceleration of the exit of non-viable firms.

In the corporate sector, while much progress has already been achieved, the overall level of corporate debt remains high. Although the debt-to-equity ratios have fallen by half since the 1997 financial crisis, according to the staff, corporate debt still represent more than 100 percent of gross domestic product (GDP). Furthermore, the country had not fully resolved issues surrounding non-viable companies and government loan guarantees, particularly of the larger corporations, which could all become future liabilities.

As mentioned earlier, the large corporate debt problem poses a substantial risk to the soundness of the financial sector, particularly if the economic slowdown is prolonged. While significant measures have been taken to strengthen Korea's financial sector with the consolidation of the banking system and improved prudential regulations and supervision, the banking sector is still undercapitalized, as its loans to distressed companies represent 100 percent of their capital. In the short run, the persistent rollovers of corporate debt may also create a credit crunch. While, the government's early takeover of corporate bonds for the second half of the year could help avoid a credit crunch when a substantial amount of corporate bonds matures, this represents however only a temporary solution, and would hinder the development of an effectively functioning bond market. It would also increase the government's liabilities in these ailing companies, thus resulting in large financial losses for the public sector. As the staff points out, the fundamental solution would be to accelerate the operational and balance sheet restructuring of these companies.

Meanwhile, it is also important for the authorities to press ahead with efforts to restructure and strengthen the banking sector so that it can better withstand any fall-out from the corporate sector. We concur with the staff that the re-capitalization of banks should be a priority, and the operational capacity and risk management of the financial system should be strengthened so that appropriate credit assessments and the effective monitoring exposures to the corporate sector can be made. Furthermore, it is important to eliminate the conflicting role of the government as shareholder and supervisor of financial institutions, by reducing government' ownership in these institutions. We therefore welcome the authorities' intention to rehabilitate some nationalized institutions as a first step toward privatization.

Before concluding, we would like to turn to fiscal policy. We agree with the staff that the sharp tightening of fiscal policy in 2000 may have contributed to the current slowdown and should not be repeated in 2001 in the context of a weaker economy. Our concern is that the fiscal stimulus may not occur, particularly that the past years' experiences show that budget allocations were repeatedly not fully implemented. We therefore support the staff in stressing the importance of full budget implementation.

Mr. Mori submitted the following statement:

Korea's economy has performed remarkably since the Asian financial crisis with two consecutive years of very high GDP growth rate—of 10.9 percent in 1999 and 8.8 percent in 2000. This strong recovery has been led by exports especially in the electronics sector. In the recent months, affected by the global slowdown and, in particular, the decline in information technology (IT) spending by the United States, growth has been decelerating, though unemployment remains low. The staff projects a growth of 3½ percent for 2001, while the authorities seem to be more optimistic estimating a growth of 4–5 percent. In any event, given the uncertainties surrounding the global economy, it seems to be difficult to make a precise estimate at this stage because it depends not only on the effectiveness of stimulative policies implemented by the authorities, but also on developments elsewhere.

Indeed, there seem to be indications that economic growth is slowing more rapidly than expected, requiring active macroeconomic policies to support economic growth. Given the Korean economy's strong external position, as well as weak demand pressures on prices, the authorities have sufficient flexibility to ease both monetary and fiscal policy. The recent cut in interest rates by the Bank of Korea was appropriate, and there seems to be room for easing further if developments in the economy so require. The considerable surplus of 2½ percent of GDP by the central government recorded in the first five months of 2001 will allow the necessary margin for a more expansionary stance for the rest of the year.

For the objectives of post program monitoring, the external position of Korea has strengthened significantly. The current account balance remains in surplus, and is projected to be about 2½ percent of GDP in 2001. Weaker exports tend to be offset by a decline in imports as domestic demand slows. In addition, the recent tension in some emerging markets seems not to affect Korea. Domestic financial markets have been relatively calm, and the exchange rate has remained fairly stable. Foreign reserves have increased to $97 billion, so that Korea is now a net external creditor.

An unfinished agenda is the restructuring of corporate and financial sectors. In this respect, there seems to be less concern in terms of external vulnerability. As the staff notes, even though corporate sector weaknesses could result in new financial sector problems, these are unlikely to spill over to a balance of payments crisis. The actions taken by the authorities have had a positive signaling effect on the market expectations. We are pleased to see that they continue to be fully committed to implement the necessary measures to restore the economy to full strength.

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

The illuminating charts in Figure 2 of the staff report show how the spread of sovereign bonds is declining while corporate spreads are widening. This indeed seems to illustrate the present state of the Korean economy. Compared to the crisis period of three years ago, the external vulnerability of the Korean Economy has been reduced thanks to a more flexible exchange rate and ample foreign reserves. This has substantially reduced Korea's vulnerability to another crisis. However, the slow progress on corporate sector restructuring is making it difficult for that sector to become the engine of growth and strong foundation of the domestic economy. Also, even though the effects of the slowdown in global growth have already been accounted for in the growth forecast for 2001, they should not be taken lightly. What the authorities now need to do is to implement accommodative macro economic policies in order to give a boost to the economy, and to pursue further structural reform. In this connection, we hope that the authorities remain vigilant in their reform efforts even though there will be elections in the foreseeable future.

The downward revision of growth from 5 percent to 3.5 percent takes into consideration the negative effect the global downturn of demand in high-tech products will have on the performance of corporations. According to the National Statistics Office, however, wholesale and retail sales seem to be improving, indicating a pickup in business and consumer sentiment. Even so, in order to turn around the weakened household consumption and the negative stance toward investment, and taking into consideration that the high-tech recession is externally-oriented, it will be necessary to boost economic activity through fiscal stimulus. In so doing, it will be important to target areas where the effects will be strongest, and to be mindful not to merely frontload expenditure on projects the details of which are not firm. Concerning monetary policy, the staff dismisses the present inflation rate of 4 percent as reflecting increased food prices due to the adverse weather conditions of last year, the oil price hike, and the depreciation of the won—in other words, as being only temporary—and they believe there is room for further monetary easing. The authorities have twice since the beginning of this year pushed down interest rates and have shown their flexibility in this regard. However, whether there will be a second-round effect on price increases is yet to be seen. Moreover, given that the authorities have only recently introduced inflation targeting as their framework for monetary policy implementation, the detrimental effect that missing the target only moments after its introduction will have on policy credibility should not be taken lightly, and in this context a cautious stance toward further monetary easing is warranted.

More importantly, in order to place the economy on its potential growth path of 6 percent, it continues to be important to further the restructuring of the chaebols, which remain the greatest risk factor in the economy. Even though debt ratios are declining, it seems that for many companies this has been achieved through the issuance of new equity, and de-leveraging has not been done to any large extent. One-fourth of companies still have an interest coverage ratio of less than 1. It also seems that there has been a slowdown in the pace of chaebol restructuring, resulting in a worrying erosion in external confidence. If the slowdown were backed by legitimate concern on the part of the authorities about the detrimental effect that drastic restructuring could have on the economy given the weak external environment, some phasing of reform would be to some extent understandable. But in such a case, it would be important for the authorities to at least have a credible timetable, to convey the idea that progress is being made on restructuring. However, the authorities cannot afford to be perceived to be merely shelving the problems, or losing the momentum because of next year’s elections.

The restructuring of the corporate and banking sectors affect one another. Therefore, it is important to maintain the health of the banking sector, even during drastic corporate restructuring. The re-privatization of the banks is a welcome move in creating the basis for normalizing the relationship between the banks and the corporations. However, it might be better to wait for more favorable market conditions. On the relationship between the authorities and the financial sector, it seems that this is shifting from direct intervention to a more indirect relationship through regulation and supervision. In this connection, it will be important to ensure that proactive risk management is undertaken by the FSC and FSS. It will be especially important for them to be aware of new risks emerging from new methods of funding being carried out by the corporate sector.

Concerning the relationship between the corporate and financial sectors, it is welcome that market selection is playing a role and companies in a precarious situation are now increasingly becoming unable to roll over their debt. There is no longer concern that the debt market is dysfunctional; however, given that nearly one-half of the debt outstanding will reach maturity in the latter half of this year, developments must be watched very carefully. The bond purchase scheme by the KDB has functioned well to allay market concerns, thus avoiding another financial crisis. That said, an over presence of the public sector is generally the cause of delay in restructuring; and therefore it will be necessary to carefully observe whether the market functions properly before considering implementing any measures toward the end of this year.

Although this was not specifically included as a topic in this post-program monitoring discussion (but was discussed in the previous report), we would like to stress the importance of developing the capital market in the medium term. At present, the Korean economy is being dragged down by the difficult reforms of the chaebols as well as the sluggish performance of the export sector, which is highly reliant on the high-tech industry. To overcome this, fostering new industry and new businesses will be key. The chaebol is deeply rooted in the Korean economy, but at the same time we hear that entrepreneurship is thriving. Development of the capital market would facilitate the financing necessary for these businesses. Needless to say, it is important to have a healthy banking system so that funds can also be provided through this channel.

On the external balances, we commend the authorities for achieving a comfortable level of reserves and for steadily reducing their debt; and we note that all of the outstanding amount owed to the Fund will be repurchased by the end of the month. From the standpoint of Fund exposure, Korea may no longer be the subject of a post-program monitoring, and we would like to once again commend the authorities for the reform efforts they have made so far. However, it is still evident that the economy rests on precarious grounds, and much still needs to be done. We therefore urge the authorities to increase their efforts, and wish them success in their endeavors.

Mr. Daïri submitted the following statement:

We thank the staff for a clear and well-written report and Mr. Callaghan and Mr. Cho for their illuminating statement. As the latter state, in looking at the Korean economy today, it is important not to lose sight of Korea's many achievements since the 1997 crisis and the remarkable transformation that the economy has undergone. Indeed, the fact that so much has been accomplished is the reason why the economy is strong enough to weather the deterioration of the external environment. The fiscal position is sound, inflation is under control, the current account remains healthy, and foreign exchange reserves exceed by far the level of short-term debt. Moreover, good progress has been made in dealing with the complex issues of restructuring and financial consolidation in the financial and corporate sectors.

Nevertheless, as recognized by the authorities a substantial agenda of reforms remains and stronger implementation is needed to build on the accomplishments of the last three years. To begin with, in the present environment of weak domestic demand and slowing growth, macroeconomic policies need to be refashioned to be more supportive of growth. We trust that the recently submitted supplementary budget will foster efforts towards accelerating spending and deliver the needed fiscal stimulus. The high-level inter-ministerial monitoring committee will have an important role to play in ensuring that expenditure allocations are spent in full. On budget practices generally, we are pleased to note that the authorities are in the process of assessing how the recommendations of the recent FAD's report could be implemented. With few risks to price stability or the won, there also appears to be a good case for "a bias towards a modest further monetary easing" so that both fiscal and monetary policies are geared towards supporting activity. To preserve the credibility of the inflation-targeting framework, we agree with the staff that it would be important for the BOK to explain to the public the reasons for the likely breach of the inflation target for 2001 and why it would be appropriate to accommodate it. Exchange rate policy has been managed with commendable flexibility in both directions with intervention limited to only a few instances and we welcome the authorities' intention to continue with this policy.

The challenges facing the authorities in pursuing their structural reform agenda remain considerable. This is understandable since the task is complex and time-consuming. Moreover, the upcoming local and presidential elections will constrain the speed with which the authorities can move in the period ahead as they try to minimize social unrest at a politically sensitive time. Nevertheless continued visible progress with corporate restructuring and restoring financial sector soundness will be needed so as not to loose the momentum that has been built up or shake market confidence in the government's commitment to reform.

The authorities' handling of large firms in distress through rescue packages is off to a good start and, if successful, could serve as a powerful boost to market sentiment. We agree with the staff that to ensure success of this operation it would be appropriate that contingency plans be prepared for selected large cases that would include the appointment of a court receiver and a stay on creditors' claims. The task of restructuring more generally would be helped by further reforms of the insolvency system. The recently introduced pre-packaged bankruptcy system is a step in the right direction but should not detract from the need for an amendment of the bankruptcy law that would include stronger "cram down" provisions. The authorities recognize the shortcomings and pitfalls of the existing procedure and are working toward amending the bankruptcy codes—a massive undertaking that will require a wide consensus within the government. We hope that this consensus will be forthcoming given the importance of the issue to corporate restructuring. Like the staff, we are concerned with the increase in government guarantees in the bond market and the moral hazard it creates in postponing the necessary restructuring but note the intention to terminate the scheme at the end of this year as the bond market shows signs of improved performance.

We commend the authorities for their decision to re-privatize nationalized financial institutions that were acquired at the time of the crisis. As Mr. Callaghan and Mr. Cho state, reprivatization is "an important step towards normalcy" and we hope that this process can be completed speedily so that the tensions created by the existence of the large government presence in the financial system can be eased and banks and other financial institutions can drive the process of restructuring forward.

We agree with the staff on the need for firmness in dealing with chaebol attempts to resist efforts aimed at instilling international best practice of corporate governance. We encourage the authorities to step up efforts to conduct more effective consolidated supervision as well as strengthen cooperation between government agencies involved in the financial sector. The planned FSAP exercise should provide an important opportunity to assess progress in these areas.

Mr. Vittas and Ms. Manno submitted the following statement:

The authorities should be commended for the substantial progress they have made over the past few years in strengthening Korea's external position. As a result of this progress Korea's vulnerability to balance of payments crises is now very low. However, the corporate sector is still suffering from high debt levels and low profitability and financial sector vulnerabilities have not yet been fully addressed. Moreover, risks to the sustainability of the economic recovery persist, partly because of the weakening of the global environment but also because fiscal policy has turned out to be overly restrictive.

We agree with the staff that in the present situation macroeconomic policies should be geared to supporting economic growth. They need to be accompanied by further decisive actions to redress the remaining weaknesses in the corporate sector and to put the financial system on a sound footing.

Fiscal Policy

The fact that the budget balance in 2000 was nearly 5 percentage points of GDP stronger than proposed in the initial budget suggests that there may be significant shortcomings in existing arrangements for monitoring fiscal developments in the course of the year and assuring the implementation of fiscal plans. These difficulties appear to have persisted during the first five months of the year, although we recognize that weather conditions have also contributed to the substantial delay in construction outlays and the resulting much tighter than intended fiscal stance. We hope that this shortfall will be fully made up in the remainder of the year and would encourage the authorities to take additional fiscal action to stimulate demand, should this prove necessary.

Looking forward, we welcome the authorities' intention to implement the recommendations of the FAD technical assistance mission with a view to improving the accuracy of fiscal forecasting and strengthening the institutional framework for public finance management. Inter alia, this should help reduce the risk of procyclical fiscal policies in the future.

Monetary Policy

We share the view that at present monetary policy should be conducted with a bias toward further easing. However, we would also like to emphasize some medium term issues that will also need to be addressed.

First, the inflation-targeting framework will require a clear departure from the quantity approach that is still inherent in the continued use of "aggregate credit ceiling loans." Such schemes, aimed at encouraging bank lending to SMEs, appear inconsistent with a market-based monetary policy in which the distribution of credit conditions is determined by price criteria rather than quantity rationing. This is especially desirable since the access of SMEs to loans from financial institutions—the objective of the aggregate ceilings—has improved significantly since the crisis.

Second, the inflation targeting approach demands extra care to be devoted to the establishment of its credibility. This is particularly important in the early stages of its functioning. In this respect, the reasons for the likely failure to meet this year's inflation target will need to be carefully explained to market participants in order to avoid any potential damage to the central bank's credentials. More generally, attention should be given to the need to put in place an effective communications strategy with the public.

Third, given the long and unpredictable transmission mechanism of monetary policy changes on the economy and the rate of inflation (and certainly the recent capital account liberalization and the adoption of a floating exchange rate also add to the uncertainty of the outcomes), focusing on an annual inflation target might not be appropriate. Instead setting a medium-term target could add to the credibility of the system.

Corporate Sector Restructuring

The process of corporate sector restructuring seems to be only half-completed. While the basic legal framework for a more market-oriented economy has been established, by introducing reforms in the corporate and financial sectors, progress in restructuring the chaebol has been limited. Bank-led workout programs have so far focused on temporary debt relief, rather than on asset sales and operational restructuring. Also, the creditors' strategy has appeared to aim at limiting immediate losses at the expense of larger problems in the longer term.

Another worrisome development is the government's effort to encourage financial institutions to support firms with serious balance-sheet problems. The underwriting program of the Korean Development Bank, as well as the "collateralized bond obligations" (CBOs) in 2000 to roll over maturing corporate bonds using partial government guarantees, raise concern that non-viable firms may be saved, thus further expanding the number of so-called "zombie" companies that absorb resources at the expense of their competitors. However, we are pleased to note that the KDB scheme will be terminated by the end of 2001.

Other Issues

We welcome the decision of the authorities to participate in the FSAP exercise. We would encourage them to consent to the publication of this report.

Mr. Djojosubroto submitted the following statement:

We thank the staff for their candid report and Mr. Callaghan and Mr. Cho for their comprehensive statement. Korea has made substantial progress rebuilding and reshaping its economy since the financial crisis of late 1997. Macroeconomic fundamentals have improved significantly. The economy is more resistant to external shocks, and structural reforms have made it more market-oriented. Korean authorities deserve to be commended for their impressive recovery from the financial and deep recession that had ensued.

However, as noted by the staff, the Korean authorities are now facing a risky combination of a slowing down in the global economy and continued structural vulnerabilities in the domestic economy. It is very encouraging to see that external vulnerability has been sharply reduced, and that there are ample signs of a turnaround in the domestic economy: economic growth has rebounded; inflation has remained under control; the unemployment rate has fallen to a post-crisis low; investment including FDI has picked up; and foreign reserves have expanded. In addition, public finances remain remarkably healthy, government debt is relatively low, Korea's external liabilities stood at their lowest level since the 1997 financial crisis, and the risk of another balance of payments crisis is thus minimal. Despite such favorable developments, it remains critical for the Korean authorities to accelerate its economic growth and to tackle the longstanding weaknesses in the corporate and financial sectors in order to sustain its growth in the medium-term.

We broadly share the thrust of the staff appraisal, but would like to highlight the following comments.

Macroeconomic Policies

Fiscal Policy

We are very impressed with the authorities' efforts on fiscal consolidation that returned the budget to a surplus in 2000, four years ahead of schedule. We strongly believe that Korea's relatively sound fiscal position will allow the government considerable leeway in implementing stimulus measures to deal with the slowdown in its economic growth and the sharper than expected slowdown in the global economy. We also agree with the staff in suggesting the authorities relax its fiscal policy when the economic activities need to be accelerated. The authorities' effort to introduce a supplementary budget into the National Assembly last month is a welcomed development. We appreciate the authorities for seeking possible ways to implement the fundamental budgetary practices along the line of FAD mission's recommendations.

Monetary Policy

We commend the Bank of Korea on progress achieved with the implementation of the inflation targeting framework. We believe that the recent lowering of interest rates in the United States and Japan and the expected moderating of inflationary pressures later in 2001, as world oil price falls and the won firms, will create the extra room for the BOK to maneuver a further interest rate cut. We, therefore, concur with the staff that a shift in the bias of policy toward a modest monetary easing is appropriate, especially in the event of a weakening economy. We welcome the BOK's recent measure in July further lowering interest rates by 25 basis points to 4.75 per cent as a step to stimulate the economy.

Corporate and Financial Sector Restructuring

We commend the Korean authorities on making significant progress in the implementation of structural reforms and their commitment in tackling the remaining weaknesses in the corporate and financial sectors. The framework for restructuring is generally in place, and the challenging tasks ahead for the authorities are implementation and ensuring a stronger role for markets to drive the process. We, however, agree with the staff that Korea still needs to implement fundamental insolvency reform; operational restructuring including asset sales; and stronger financial supervision.

On the corporate restructuring front, government's effort to dismantling of the Daewoo group and to conclude the negotiations to sell two weakest Hyundai affiliates were milestones in this regard. We also note that the debt to equity ratio of chaebol has been significantly lowered; the relation between business and labor is now much more stable; a number of public enterprises has been privatized and restructured; and many government regulations have been abolished. However, we agree with the staff that the country's major chaebol conglomerates remain highly leveraged and in need of further deep restructuring. The experience so far with out of court workouts suggests that it has not done enough to resolve the fundamental corporate problems and the creditor-led workout programs need to move beyond financial stabilization and complete strategic sales, spin-offs, and other operational restructuring. We welcome the authorities' efforts to further strengthen the solvency system by amending the bankruptcy law that will reinforce the court supervised workouts; to improve the governance by pressing ahead with plans to allow class action law suits by shareholders; and to maintain an open attitude to foreign involvement in the restructuring process.

In addition, we have noted that Korea is pursuing a knowledge, information, and digital based economy while nurturing venture business equipped with innovative ideas and technology. The new ventures have brought about new fundamentals such as introducing a performance-based scheme to the workforce and offering their employees stock options. The number of companies listed on the Korea stock exchange that offer employee stock options has now increased to more than 100 from only 2 companies in 1997. We would suggest that the authorities enhance this momentum gained in Korea's corporate culture that will make its rigid labor market more flexible.

In the financial sector, we commend the authorities' announcement of their intention to re-privatize nationalized financial institutions. We are fully aware that the restructuring in the financial sector is gaining momentum with the formation of the Woori Financial Holding Company, which groups four commercial banks and a merchant bank and have been recapitalized with public funds. The authorities' plan for the early sale of Seoul Bank is a welcomed development. It is also very encouraging to see the improvement in loan provisioning and a decline in impaired loans, owing to securitization, write-offs and loans recovery. However, we wish to urge the supervisory authorities to step up efforts to conduct more effective supervision in order that they are up to international best practices.

Ongoing pressures in the corporate bond market are another sign of the need for further restructuring. There is anxiety that persistent rollovers of corporate debt may create a credit crunch later this year as a large hump of corporate bonds mature in the second half of this year. A few companies with good credit rating may be able to roll over their payment by finding buyers for new issues. However, Korea's healthy public finance position suggests that this can be dealt with by the government's involvement through KCGF and KDB despite concerns of corporate and financial bail-outs, rather than necessary restructuring. With regard to the development of the bond market, we suggest that the authorities ensure that intervention in the bond market does not slow corporate restructuring. Moreover, we would like to encourage the authorities that government guarantee should not become widespread. In this regard, we commend the authorities' intention to terminate the KDB underwriting scheme by the end of 2001.

Before concluding, we praise the Korean authorities for their impressive achievements over the past three years. Although difficult challenges still lie ahead, we believe that the silver lining to these challenges will be the authorities' strong commitment to accelerate the corporate and financial sector restructuring process and some favorable macroeconomic performances including the minimal risk of another external crisis.

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

Ms. Lundsager made the following statement:

This post-program monitoring report clearly indicates the strength of Korea's balance of payments position and the authorities deserve credit for the turnaround they have achieved in the past few years and their reductions in external vulnerability. We also very much welcome Korea's actions, in repaying the Fund early. Korea will complete that repayment very shortly. We think that is a very strong indication of their commitment to achieving the goals of their program over the last few years.

At this time Korea's key economic vulnerability is the instability in the domestic financial markets, stemming from the legacy of overleveraged corporations and the transformation of the financial system toward a more market-based capital allocation system. Given the more difficult external environment, we note that a more rapid restructuring of domestic banks and corporations would allow Korean firms to better compete internationally and attract foreign investment. Strong action would, and I quote Mr. Callaghan's and Mr. Cho's statement, "help convince international investors that Korea is not just another emerging market."

What I would like to do is just highlight a few items of particular importance, noting that this report on post program monitoring is right on the mark and highlighting the vulnerabilities going forward, while making very clear the achievement of external viability that the Koreans have attained.

First, I think the most important thing is reprivatization of the financial system. This is very important for reforming the financial sector, which is underway but needs to be concluded. The government's current role as supervisor, owner, and guarantor of financial institutions inhibits the creation of a market-based system, retards corporate restructuring, and exacerbates moral hazard. It undermines the value of moving from a blanket guarantee on deposits to a more limited deposit insurance scheme. A privately owned financial sector would help advance corporate restructuring and improve the efficiency of capital allocation, because there would be much less pressure from the government in terms of how to allocate resources. Greater foreign participation in the financial sector could further assist financial institutions in credit analysis and risk management and help strengthen capital positions. We encourage the authorities to give reprivatization of the financial sector very high priority, and we also welcome the authorities' plan to conduct an FSAP later this year.

Progress on corporate restructuring is slow and appears to be undermined by several ongoing policy actions. I think this is the second very important area that was highlighted in the staff report. First, the growth of government contingent liabilities, stemming largely from the issuance of government guarantees for bond rollovers, is clearly excessive, amounting to over 3 percent of GDP this year. These contingent liabilities are growing in part because creditors are choosing not to roll over bonds for overleveraged and unprofitable corporate debtors, but this result is a reflection of market forces, not market failure. While the KDB underwriting scheme will be phased out at year-end, we would appreciate the staff's comment on the extent to which other avenues for government support or guarantee could still be continued.

Second, the injection of working capital into nonviable firms by the banking sector that is still heavily government-owned and managed merely results in further losses and drains scarce financial resources from other enterprises, particularly small- and medium-sized enterprises, which are the expected source of job creation, as the chaebol are scaled back.

Third, we understand that there are initiatives to allow the chaebol to own banks after they divest themselves of their holdings. This proposal raises obvious concerns about future bank lending practices, and we would appreciate the staff's information on that.

Fourth, regarding bankruptcy procedures, slow progress in improving the legislation suggests that nonviable firms will continue to claim large amounts of public and real resources. We note that the analysis in Box 2 suggests that more aggressive action on loans of distressed corporations would not pose a systemic risk to the banking sector.

On the monetary side, we would note there has not been an agreement of views expressed in the preliminary statements. Certainly there is some diversity of view regarding the way monetary policy should go. First of all, the authorities are allowing the exchange rate to move more than in the past, and that is a very important step. In February, when we last discussed Korea, the staff noted that the credibility of the inflation targeting framework was still uncertain. Although poor growth has argued for a loosening of monetary policy, the Bank of Korea has only recently cut interest rates. With core inflation projected to slightly exceed the formal target this year, the Bank of Korea was probably correct to wait. Their current policy dilemma is to weigh low demand pressures against sizable projected growth in M3 and private credit. The staff makes the point that there is little threat to medium-term price stability. However, we are not so certain that the case for further monetary easing is that clear, particularly given that real interest rates are already low. So, I would appreciate the staff's sense on how the interest rate affects real economic activity.

I think Korea is at the point where structural reforms need to continue to make a very strong impact of the economy. Mr. Callaghan and Mr. Cho have made an important point in their preliminary statement about making sure that there is enough momentum going into the elections so that it will be sustained. My question for the staff is a sense of what is going to be the largest impact on growth now. Will it be more structural reform or is it really going to come from further monetary easing—a sense of the role of structural reform versus macroeconomic policy going forward? One related question I have is how effective monetary policy easing is in stimulating the expansion of the small- to medium-sized enterprise sector. Mr. Vittas and Ms. Manno suggested that those enterprises are being supported in other ways. What I would like to know is how much does economy-wide monetary policy affect them, versus specific targeted measures or just more generally the structural effort going forward.

Mr. Yagi's point on developing capital markets in terms of how the medium-term outlook will evolve, I think, was very much right on the mark, because if this economy could have a more diverse set of financing sources, it might help other sectors develop more, as then there would be alternatives to the banking sector, which the chaebol still continue to dominate.

Finally, we see that it is still undetermined if the authorities will publish this staff report. Mr. Callaghan and Mr. Cho noted that the authorities have some concerns about the market reaction to Box 2 in the paper. Rather, I think Box 2 could give the public some comfort that Korea is now in a good position to take further action and that the country is not as vulnerable as it was a few years ago. Perhaps, getting that message out has some value. So, I would appreciate Mr. Callaghan's comments on what the decision is on publication.

With those remarks, I want to thank the staff for an excellent report and for very much focusing on what are the vulnerabilities in this economy.

Mr. Wei made the following statement:

We are grateful to the staff for a well-prepared set of papers and to Mr. Callaghan and Mr. Cho for their very comprehensive and helpful preliminary statement. Korea has made significant progress under the three-year arrangements supported by the Fund and since 1999 its economy has since resumed strong growth. Notwithstanding the global economic slowdown, the macroeconomic fundamentals have improved, external vulnerability has been sharply reduced, and structural reform has continued. Especially, substantial progress has been made in stabilizing the financial system and addressing corporate sector problems. As a result, the Korean economy has become more open, competitive and market driven. More importantly, the authorities have renewed their reform and restructuring efforts, clearly demonstrating their strong commitment and ownership for building a better functioning market economy. Based on the above observations, the Korean authorities deserve our commendation for what they have achieved in the periods under and after the program. That being said, important structural weaknesses remain and the corporate sector is still largely saddled with weak cash flows and limited profitability, which in turn affects the performance and soundness of the financial sector. However, we are very much encouraged by the policy measures that have been, and are being, taken by the authorities to address these issues.

We broadly agree with the thrust of the staff appraisal. As such, our comments are focused on several points and are basically for emphasis.

Economic Outlook

We take note of the recent indicators outlined in the staff statement, which point to a further weakening in growth prospects for 2001. In the meantime, as Mr. Callaghan and Mr. Cho emphasize in their preliminary statement, a series of positive driving forces are behind the authorities' more optimistic growth forecast for 2001. In addition to the encouraging consumer and business confidence and low unemployment as outlined by the staff, just to name a few, these forces include accommodative fiscal and monetary policies, improved industrial relations and a buoyant service sector. We wonder if the staff is too conservative in its growth forecast for 2001. Staff comments are welcome.

Fiscal Policy

We welcome the authorities' recently announced intention to ease fiscal policy by accommodating up to 1 percent of GDP fiscal deficit for 2001, and believe such a move is appropriate, particularly given that the downside risks cannot now be totally ruled out. We hope that the supplementary budget will be approved by the National Assembly and implemented in a timely manner, to inject new stimulus into the economy, and look forward to welcoming the positive outcome of this policy.

Monetary and Exchange Rate Policies

We also welcome the recent interest rate cut by the Bank of Korea and its policy intention toward further easing, if necessary. In our opinion, it is appropriate given that economic growth was slowing more rapidly than expected and demand side pressures on prices were subdued. We encourage the Bank of Korea to respond quickly to economic developments while keeping the medium-term core inflation target within its announced frame.

Turning to exchange rate policy, we believe that Korea should continue to maintain a more flexible exchange rate regime, allowing the currency to move on both sides. In this connection, we welcome the authorities' non-interventionist policy and their commitment to smoothing-out operations and to confining their interventions to exceptional cases when market conditions are in extreme disorder. We agree with the staff that interventions should not be attempted to defend the won at any particular level.

Corporate and Financial Sector Restructuring

Since the inception of the Fund-supported program, it is fair to say that substantial progress has been made in corporate restructuring, including improving its financial structure and strengthening corporate governance, as well as enhancing the role of market discipline. It is worth noting that all the progress was made under difficult circumstances, including the deeply rooted corporate culture and opposition from the vested interests. We appreciate all the accomplishments in this direction and are encouraged by the measures recently implemented as indicated by Mr. Callaghan and Mr. Cho in their preliminary statement, including the establishment of the Woori Financial Holding Company. Having said that, we concur with the staff that the continued support of nonviable firms could be very costly and these companies should be restructured in such a way as to be profitable. Therefore, we would join the staff in encouraging the authorities to continue to streamline the insolvency process to accelerate the corporate sector restructuring efforts so that its overall cash flow and profitability could be improved. Accordingly the soundness of the financial sector could be strengthened.

Significant progress has also been made in financial sector restructuring. We are pleased to learn that non-performing loans in the banking sector have been substantially reduced. However, weaknesses in the financial sector continue, particularly, the quality of bank assets needs to be further improved to make them competitive in international terms. To this end, we encourage the authorities to redouble their efforts to improve the soundness of the financial system. Nevertheless, we are reassured by the authorities' overall agenda to further restructure the financial sector.

Stress Tests in Financial Sector

We share the concerns expressed by Mr. Callaghan and Mr. Cho in their preliminary statement. Such concerns are justified, particularly at a time when the economy is slowing down and the market is highly volatile. We certainly do not want to see such a self-fulfilling phenomenon, which could undermine market confidence. Therefore, we would suggest that such scenario exercises be strictly kept as exercises and for internal discussion only.

Finally, we would like to commend the authorities' plan to make early repurchases of the remaining outstanding credit to the Fund by end-August 2001, which is another indicator of how successfully the economy has performed.

With these remarks, we wish the authorities continued success for their structural reform endeavors.

Mr. Hendrick made the following statement:

I would like to thank the staff for a clear and concise paper on the progress under the post-program monitoring. The recovery of economic activity and lower unemployment rate during the first quarter of 2001 are encouraging developments. The fiscal sector has registered surplus during the first five months of the year and the external position, measured by the increase in official reserves is stronger. In the structural front, the Korean authorities have made important progress to deal with the corporate sector distress and for the actions taken in the legal framework to facilitate out-of-court workout procedures. Recent steps to strengthen the resilience of the banking system, including the Woori Financial Holding Company are also welcome. Due to this progress and the maintenance of sound macroeconomic policies, it is fair to recognize, as highlighted by Mr. Callaghan and Mr. Cho in their comprehensive and very useful preliminary statement, that the instability of the world economy is unlikely to destabilize the Korean economy.

Nevertheless, the main downsize risk, a slowdown in economic activity, seems worse than envisaged in our last Board meeting. Despite the improvement in business and consumer confidence, and the rebound in domestic capital markets, domestic and external demand remain weak and, as indicated in the staff update, GDP growth for 2001 would need to be revised downwards. The authorities are doing the same albeit with some more optimistic expectations. The speed of recovery of the U.S. economy, Korean's major export market, will play a key role in the fulfillment of these expectations.

Against this backdrop, some counter cyclical policy is warranted. On the monetary side, we welcome the Bank of Korea's decision to cut the target for the overnight call rate by an additional 25 basis point to 4.75 percent, the second in a year. I concur with the staff that the bias of policy towards further easing is an appropriate signal to the markets. The BOK is following a prudent approach on the easing of monetary policy, which I support. As emphasized by Mr. Vittas and Ms. Manno, establishing credibility in the early stages of an inflation-targeting scheme is crucial. Also, as highlighted by Ms. Lundsager, it is not clear if there is room for further easing of monetary policy. In spite of lower domestic demand, headline and core inflation are higher than expected. June inflation pushed the price index up to 5.2 percent year-on-year (above the original forecast for the year 2001 of 3.0–4.0 percent and well above the 2½ percent medium-term target). I wonder if 2001 inflation could go beyond or near 5.0 percent, either because of additional lagged effect of the country's severe drought on food prices or because of the public service fee increases, not to mention a possible further depreciation of the won. If this were the case, and the slowdown of economic activity persists, then would the staff support further easing of the monetary policy?

On the fiscal sector, the 2.5 percent surplus accumulated during the year by the consolidated central government provides enough room for a prudent fiscal stimulus. It is unfortunate that because of the weather, the envisaged front loaded expenditure for the first quarter was not implemented. In this regard, although an increase in expenditure is expected during the second half of the year, because of the typical seasonal pattern, I wonder if the operating ministries and provincial governments have the capacity to spend in the remaining five months of the year, not only the spending included in the original budget, but also the supplementary budget presented to the National Assembly in June, which theoretically will increase the 2001 fiscal deficit target from 0.2 percent of GDP to nearly 1 percent of GDP. How this stimulus could be achieved? The supplementary budget is mainly current or capital expenditure? How the high-level inter-ministerial monitoring committee will ensure the full implementation of the budget's expenditure allocation? The staff's clarifications are welcome.

I concur with the staff that, standard indicators of external vulnerability suggest a low probability of a balance of payment crisis. Foreign reserves are high both in terms of months of imports and as percentage of short-term liabilities on a remaining maturity basis. Exchange rate flexibility—in both directions—with minimal central bank intervention is commendable and it has been playing a crucial role in protecting the hard won level of official reserves. However, we should keep in mind that the current account surplus is reflecting the slowdown in economic activity and not a surge in net exports due to higher productivity. Indeed, exports fell in June by 13.4 percent, the largest year-on-year decline for 26 months, and the fourth consecutive fall. The slowing overseas demand, is mainly affecting the semiconductor exports, which alone accounts now for 10 percent of Korea's GDP and a third of its exports. The slowdown in economic activity can make more difficult the recovery of the corporate and the banking sector. Despite some good indicators, corporate sector remain weak as shown by the widening of corporate spreads as illustrated in the staff report.

Thus, the cornerstone of the authorities' program still is the efficient and timely resolution of the corporate and financial sector restructuring. That explains why, seven out of the ten key issues to be monitored under the PPM are concentrating in those areas, as described in Annex 1 of the staff document. In this regard, we are encouraged by the commitment expressed by the authorities to speed up the process, as detailed in Mr. Callaghan's and Mr. Chow's statement. As they recognize, there are only slightly different views on some points. I would only like to comment on the insolvency system. I tend to agree with the authorities that the recent legislation passed by the National Assembly, providing a legal basis for the existing out-of-court workout procedure, does not need to undermine the efforts for improved court-supervised insolvency procedures. However, I am not clear from the staff update, paragraph 8, why this new legislation could erode the flexibility associated with voluntary out-of-court negotiations. I would also like to know what is the current average length of time for the resolution of a bankruptcy procedure in a court of law. Staff comments would be appreciated.

Box 1 provides a good description of the problems with weak affiliates of the Hyundai group. The successful US$1.25 billion international equity issue for the Hynix Semiconductor is good news. In relation to the Hyundai Engineering and Construction (HEC) Corporation, I believe that the main creditor banks make a right decision not to place HEC under court receivership and instead proceed with a massive debt-equity swap. After all, the government is the largest single shareholder in the two main creditor banks. This is consistent with the overall privatization strategy of maximizing the recovery of injected public funds. However, the authorities will need to strike a right balance between this objective and the need for a rapid resolution of the remained distress corporations. It is a matter of assessing the intertemporal cost and benefits of those decisions not only on the fiscal accounts but also in the economy as a whole.

On the simulations of the impact of declining credit quality on bank capital illustrated in Box 2 of the staff report, I concur with the authorities' view that the underlying assumptions in scenario II are extreme, but at the same time, it is fair to recognize that the staff made clear that this scenario does not include exchange rate, market and interest rate risk nor the impact of a further worsening in macroeconomic conditions on loan quality. In this regard, our view is that if the authorities are planning to publish the PPM report, I believe this could be a case for market sensitive information that could be deleted in the final version for publication. In any event, the planned FSAP exercise scheduled to start later this year will shed light on these issues. Mr. Callaghan's comments are welcome.

With these remarks, we wish the Korean authorities success in their challenges ahead.

Mr. Jonáš made the following statement:

From the perspective of the post-program monitoring, we do not have any major concerns about Korea. Indicators of external vulnerability have improved significantly, and the record-high foreign reserves and flexible exchange rate provide an important cushion in case of adverse balance of payments developments. External sustainability thus does not seem to be a problem, and the Fund arrangement has achieved its purpose. This is also confirmed by the relative resistance of Korea's financial indicators to recent emerging market turbulences.

Taking a broader perspective on developments in Korea, the picture is less encouraging. The weakening of export growth has been very sharp, and in combination with financial vulnerabilities in the corporate and financial sectors, it presents a serious threat to future growth prospects. We have discussed the issue of corporate restructuring in detail during the Article IV discussion, and I am not going to get into detail on that. I would like to note, however, that I agree with those Directors who have expressed concern about the slow pace of corporate restructuring.

I think that, in view of the comfortable external position, more expansionary macroeconomic policies are appropriate. The Bank of Korea could perhaps ease monetary policy further, but I think they are about through with interest rate cuts. However, the Bank still announces both medium-term and annual inflation targets, which could complicate its communication policy. Focusing on a single medium-term target would facilitate the communication and it could somewhat increase latitude for a rather more relaxed monetary policy, without the concern that this would damage the Bank's credibility. There is certainly some tradeoff between transparency and credibility, which the authorities could explore.

As for fiscal policy, the tighter-than-planned fiscal stance is not very helpful. In Korea, there seem to be serious problems with using fiscal policy as a flexible countercyclical tool. However, it is not exactly clear where the problems are, and perhaps the staff could tell us more about the reasons. The authorities argue that the delay in frontloading public expenditures was mainly caused by cold weather, but I think that this is only a partial explanation, because the problem is more persistent than cold weather. Is there a problem with the working of automatic stabilizers, perhaps because of an underdeveloped social safety net? Also, I note that unemployment is falling at the same time as economic activity weakens. Does this signal insufficient progress with corporate restructuring? What about the effect of one-off revenues from auctions on the budget balance this year? If this effect is taken out, what will be the status of the budget balance? The fact that the budget balance is stronger on account of revenues from the sale of assets should not count as fiscal tightening. Also, what is the scope for effective fiscal stimulus? As we know from other countries in the region, increasing fiscal spending is not always effective in stimulating economic activity in a sustainable way. I wonder how the staff assesses the quality of fiscal stimulus envisaged by the authorities. I note that they plan, for example, to increase government-funded investment into real estate and infrastructure projects. I am a bit concerned that this form of fiscal stimulus could work at cross-purposes with the need of corporate restructuring.

Mrs. Mateos y Lago made the following statement:

The report produced by the staff for this last PPM consultation illustrates well that there can be quite a gap between restoring external viability and leaving the economy on a sound footing. Indeed, while Korea's balance of payments appears impressively strong, the corporate and financial sectors are still plagued with serious problems, the short-term economic outlook is clouded, and it is unclear how much support macroeconomic policies will be able to provide to domestic activity.

No doubt though, even leaving the external dimension aside, the Korean economy has achieved tremendous progress since it entered into a lending relationship with the Fund four years ago, above all, perhaps, as far as transparency is concerned. Looking at the degree of detail of the analysis provided by the staff as regards both the corporate and the financial sectors, I could not help finding it encouraging that at least we have such a realistic picture of the situation. Another achievement, which may not be unrelated with increased transparency, is that according to the staff, markets now function properly as far as the allocation of credit is concerned. Maybe this is the right time to ask: could the restructuring of the corporate and financial sectors have proceeded faster? And, if they had, would the sharp slowdown in growth currently experienced by the Korean economy have been prevented or mitigated? Also, given where the reform process stands, how serious is the risk of reversal, or even of status quo? I would appreciate hearing the staff's views on these questions, if only to form a preliminary opinion, with the limited hindsight available at this juncture, as to whether or not the Korea program can be viewed as successful and regarding the extent to which the program design contributed to that outcome.

Turning to the challenges that lie ahead for the authorities, I fully agree with the staff appraisal and will only insist on selected issues for emphasis.

First of all, as far as macroeconomic policies are concerned, the inability of fiscal policy, to date, to provide the intended stimulus is an issue of concern. While there might have been temporary, exogenous causes to this, it is not the first time such a setback has happened, and we can only join the staff in urging the authorities to make an in-depth review of budget practices, so as to allow fiscal policy to be used as an effective counter-cyclical tool. The measures to increase and accelerate spending described by Mr. Callaghan and Mr. Cho in their statement are encouraging, but as far as further stimulus is concerned, given the lags involved, I would like to ask the staff whether it may not be too late for fiscal policy to play that role at this stage of the cycle.

As regards monetary policy, considering the uncertainties surrounding the short-term effectiveness of fiscal policy, we see merits in the staff's suggestion for a modest bias toward further monetary easing, in view of the absence of noticeable demand pressures. However, given the recent up-tick in inflation and probable breach of the central bank's target for this year, it would be critical that such a move be thoroughly justified and explained to the public so as not to undermine the nascent credibility of the inflation targeting framework, and we fully share the views expressed by Mr. Vittas and Ms. Manno in that regard.

Second, regarding the restructuring of the corporate and financial sectors, the staff has rightly pinpointed the key areas where further government action is needed to remove the remaining obstacles to more thorough progress. Going farther in the reform of the insolvency system and the strengthening of financial supervision may be the most important among them. Prioritizing the handling of the difficulties of large distressed firms would also be necessary. In other areas, what is needed is not government action but rather inaction or withdrawal, i.e., inaction against chaebol's calls to relax regulations and to dilute corporate governance, and withdrawal from public guarantees schemes and from nationalized financial institutions. As the prospects for such a withdrawal do not appear very favorable in the very short run, it would be important to make sure that the institutional setting allowed for a satisfactory and transparent resolution of actual or potential conflicts of interest arising between the roles of the government as a supervisor, a guarantor and an owner.

An exogenous development which will complicate the authorities' task in pushing this process forward is the slowdown of the world economy, which not only weighs down on growth, but is also likely to dampen foreign investors' appetite for participation in the restructuring process. Against that background, the authorities are understandably wary about the social implications of aggressive restructuring, especially in labor intensive sectors. However, from our standpoint, it would be preferable to strengthen social safety nets rather than artificially to keep in activity unviable enterprises. The recent improvement in industrial relations noted by Mr. Callaghan and Mr. Cho and the very low level of unemployment provide a supportive environment to press ahead with the restructuring process at a limited social cost. Thus, we encourage the authorities to take advantage of it while it lasts.

Finally, we welcome the authorities' decision to participate in the FSAP by the end of the year and look forward to seeing the results of that exercise.

After adjourning at 1:05 p.m., the meeting reconvened at 2:40 p.m.

Mr. Fenton made the following statement:

The staff is to be commended for producing another well-written, concise report on Korea, with a good choice of topics and a great deal of sound advice. The only area where my views differ somewhat from those of the staff is monetary policy, but it is mainly a question of how the risks are balanced.

I agree with the staff that the risk of an external financing crisis in Korea is low for the reasons given in the staff report. There is no reasonable doubt that the Fund will be repaid. Indeed, Korea is repaying early. The real concern with Korea is that fundamental structural reforms, especially corporate restructuring, will take a long time to implement. In the meantime, structural problems will act as a drag on the economy and leave it vulnerable to negative shocks. Unfortunately, there are many examples in the experiences of other countries of the serious problems that can arise when a country fails to deal decisively with structural problems, especially when significant cross-sector balance sheet problems are involved. Accordingly, I would like to emphasize the importance of getting on with corporate restructuring. In this regard, it is particularly important to resolve the problems of distressed, large companies, including weak Hyundai affiliates. Essentially, this requires the authorities to refrain from intervening in these cases and allowing market forces to dictate the pace of restructuring. We also encourage the authorities to follow through on their commitment to discontinue offers of liquidity support by the end of 2001. This practice allows nonviable companies access to financing, distorts market signals, and delays the restructuring process. Finally, improving the insolvency framework should be a high priority. The launching of a task force to review existing bankruptcy laws and prepare a framework by the end of this year is a welcome development. The strengthened and unified code that the task force prepares should include provisions to deal with junior creditors and for automatic standstills.

With regard to short-term macroeconomic policies, I agree with the staff that fiscal policy should be more supportive of economic growth. It is disappointing that the front-loading of the fiscal expenditure program in the first half of the year did not materialize. It is to be hoped that the high level inter-ministerial monitoring committee that has been established will ensure that the stimulus envisaged in the supplementary budget is achieved. In any event, I agree with the staff on the need for the authorities to implement the recommendations in the FAD technical assistance report, and I welcome the indication in Mr. Callaghan's and Mr. Cho's comprehensive preliminary statement that the authorities are considering the best way to address the recommendations.

On monetary policy, I am not convinced that a bias toward modest easing is advisable, especially after the July 5 reduction in the overnight call rate. While there does not seem to be overall macroeconomic pressure for higher inflation at this time, the fact that both headline and core inflation have been rising due to a series of one-off factors suggests that there is a risk that higher inflation will become embedded in expectations. This would be detrimental to the economy's performance over the longer run. It is important that the Bank of Korea preserve and enhance the credibility of its commitment to maintaining low inflation. The Bank's recent efforts to explain its policy actions are most welcome, but ultimately it takes good communication and well-chosen actions to establish and maintain credibility. Given recent price developments and the planned fiscal stimulus, the Bank of Korea should be careful not to take actions that suggest to economic agents that it is less concerned with inflation than it says. Also, the authorities should continue to allow exchange rate flexibility.

With these remarks, we wish the Korean authorities success in their ongoing endeavors.

Ms. Vtyurina made the following statement:

Like other Directors, we recognize that Korea achieved a significant deal of success in overcoming the 1997 financial crisis and we commend the authorities for that. Unfortunately, at present it seems that the economy is entering a “dieting phase,” where industrial output and corporate investment are slimming down, import demand is lagging behind the already significantly reduced exports, and labor union demands are subdued. However, the positive signs are also there, such as the drop in unemployment, lower country’s external liabilities, rebound in retail sales, and budget surplus. The fact that the won is floating and that foreign reserves are at a very high level suggests that indeed the country is not in a danger of suffering another currency crisis. We agree with the staff that given the present circumstances, the authorities should consider loosening both fiscal and monetary policies to support the slowing growth.

Having said this, there are general concerns that fiscal policy cannot be too accommodative given the contingent and growing public sector liabilities, although, paradoxically, at present, Korea is among very few countries that struggle to maintain a budget deficit. On monetary policy, markets expect that the slowdown in CPI inflation, drastically falling inputs, and the decline in industrial production will keep a lot of pressure on the Bank of Korea to lower interest rates at this month’s meeting.

It does appear that accommodative macroeconomic policies may not be sufficient to prevent the economy from further slowdown. The main apprehension about the country’s future is the structural reform agenda. Let me comment on a few issues:

External outlook: While the probability of a currency crisis is low, the performance of the external account can have significant influence on the GDP growth. It is appropriate that the staff’s projections for this year’s GDP growth based on the developments in the current account and industrial output are on the conservative side, even comparing with the consensus forecast. For the next year, however, I wonder if the projections for exports and imports are not too optimistic given the continuing slowdown in economies of their main trading partners, and especially in the global IT sector. Since the PPM reviews’ goal is to monitor external vulnerability, it perhaps would have been helpful to examine the developments in the current account given different scenarios. In this regard, I wonder if the staff can comment on their assumptions regarding the developments in trade as well as the zero net DFI flows projected for this year. Finally, the recent currency swap arrangements with Japan would have probably deserved some comments in the paper since they represent an important link in the chain of defense to make Korea less vulnerable to speculative attacks, and given the fact that some of the swaps are contingent on having a Fund program.

Corporate sector: The staff is being very candid stating that, although important developments took place in the corporate sector over the past three years, “domestic corporate weakness loom large.” While the aggregate debt-to-equity ratio decreased significantly from the 1998 levels, such ratio for Hyundai, formally the largest chaebol, has more than doubled to 447 percent from 229 percent in 1999. Profitability of chaebol is also a concern, with eight out of 13 conglomerates posting losses for the past year. The recent problems of lower rated companies with raising funds and their poor financials inevitably affect the already weak balance sheets of the banking sector. While we note that the authorities are well aware of the need to speed up the restructuring, some recent measures taken by the government to ease the business environment are widely viewed as a step back on the reform path. Although the 25 percent ceiling on cross-equity investment and intentions to introduce class action law suits remain in place, the 33 concessions, including tax benefits and the extension of grace period for disposing shares in affiliates, fuel concerns that reform is regressing at the time when the economy is slowing down as well. On the other side, chaebol remained very unsatisfied with the recent measures and are asking for more. To many market analysts the situation is reminiscent of the era of “Korea Inc.,” and with the growing interventionism of the government in the market through de facto nationalization of banks in whose state reportedly it intervenes constantly, it seems that the reform and restructuring policies have switched into stabilization policies where big chaebol remain influential players.

Problems with the insolvency system are also a key deficiency and stands in a way of the needed restructuring. This incomplete and slowing down process of restructuring has prevented Standard and Poor’s to upgrade South Korea’s sovereign rating until legal system becomes more transparent, industrial relations improve and moral hazard from direct support of specific firms, such as Hynix, is eliminated. Having said this, we support the staff’s call on the authorities to remain firm against efforts by the chaebol to weaken corporate governance and encourage them to move expeditiously in corporate sector reform area, although we can see that this may be difficult to do given the upcoming elections.

Banking sector: Although provisioning has improved, the inconsistent application of loan classification rules, underprovisioning and underestimation of potential losses remain serious drawbacks to seeing a clearer picture of the state of the banking sector. Therefore, no effort should be spared in bringing the accounting system as well as supervision to best international standards. Three developments have caught my attention recently. First is the fact that while the banking sector is in need of consolidation, it is not clear that creating financial holding companies consisting of several weak institutions is an efficient restructuring policy. Besides the fact that weak banks, separately or in a holding, still remain weak entities, there are concerns that these poorly performing entities will receive preferential treatment from this scheme, similar to the corporate workout scheme, and which shelters weak entities from creditors in return for implementing reforms while sounder and more deserving ones receive little assistance. Second, a ceiling for guaranteeing individual bank deposits has been increased to won 50 million which gives less incentive to depositors to move their funds to better-run and more financially sound banks. I wonder if the staff can confirm this. And third, it has been observed that the government is pressuring commercial banks to rally behind KDN and take a share of questionable corporate paper. Allegedly, when Korea First Bank refused to do so, it was pressured by the FSS until it complied with the request. Such actions have a direct effect on banks' balance sheets by burdening them with junk bonds, prevent an efficient functioning of the bond market, and preclude banks from making its own investment decisions. All of the above developments seem to be somewhat counterproductive to the reform effort in this sector.

Finally, I would argue for extracting Box 2 from the paper not so much because it is market sensitive, but rather because the presented scenarios are very limited in their assumptions, especially regarding the impact of the worsening of market conditions on loan quality. Since the FSAP is going to take place soon, I would suggest waiting for the results of a more thorough analysis.

Mr. Fidjestøl made the following statement:

I find the situation in Korea very interesting in many ways. The macroeconomic variables are quite strong, and some variables, in particular those related to the external sector, are very strong. At the same time, there are serious weaknesses in the corporate sector, with potentially serious consequences for the financial sector and the economy.

Korea has experienced very strong growth since the crisis, although growth has weakened lately in line with the weaker developments in the world economy. According to the staff report, production is not very far below capacity, and most of the increase in unemployment during the crisis has disappeared. The external position is quite strong, with consistent current account surpluses since 1998, high foreign exchange reserves, and limited foreign debt; the country is even in a net asset position. Moreover the strong fiscal position leaves room for fiscal easing, and the staff also sees room for monetary easing. The main problem in the fiscal area seems to be limited implementation capacity; the government has not succeeded in spending the budgeted amounts.

While the external vulnerability seems quite limited, the same cannot be said regarding internal financial vulnerability. Serious structural weaknesses in the corporate sector represents a threat to financial stability and consequently to continued strong macroeconomic performance, which is dependent on a sufficient supply of credit in order to reach its potential. Resolving the remaining structural weaknesses and putting the corporate sector on a solid financial footing therefore should be the highest priority for the authorities. I fully agree with the staff that temporary solutions or further delays in addressing corporate weaknesses will create larger problems that may prove more difficult and costly to resolve later.

In this regard, I would put particular emphasis on transparency, which is vital for informed credit decisions. Moreover, in order to facilitate restructuring, a strengthened insolvency framework is necessary. This will also help facilitate voluntary corporate workouts, which may be the preferred option in many cases.

A prominent feature of the situation in the corporate sector is that the problems are particularly acute in some of the largest firms. This puts the government in a difficult position since it is owner of major financial institutions, guarantor of corporate debt and supervisor of financial institutions. The many roles of the government may contribute to a notion that some firms are too big to fail, and it may make major stakeholders of the large firms reluctant to make a realistic evaluation of the situation. Selling the government's stakes in financial institutions and discontinuing to guarantee corporate debt should contribute to a more realistic and economically based attitude among major stakeholders in the distressed firms. Corporate governance reforms should also be pursued as part of the efforts to foster a financially sound corporate sector.

As I have already mentioned, corporate restructuring is also vital for the health of the financial sector. The present situation places a heavy burden on financial supervisors. I encourage supervisors to strengthen efforts to bring provisioning practices in the banks up to international best practice. The upcoming FSAP exercise should contribute to identify remaining shortcomings in banking practices and in supervisory practices.

Finally, I commend Korea for making early repurchases according to a schedule that will eliminate all Fund credit outstanding by end-August 2001.

With these remarks I wish the Korean authorities continued success.

Mr. Al-Turki made the following statement:

Korea's economic performance in the aftermath of the Asian crisis has been impressive. Following two years of fairly high growth rates, however, the economy weakened substantially this year. While the increase in reserves and the progress made in structural reform have improved the economy's resiliency and dynamism, the recent sharp decline in the stock market and weakness in international environment underscore the risk. Here I will add a few remarks.

On fiscal policy, I fully endorse the authorities' supplementary budget to support economic activity. We find that the fiscal stimulus in the supplementary budget is appropriate. However, at the current phase, it is essential to fully implement the planned easing. Indeed, the lack of implementation in the first half of the year is a concern, and the authorities are encouraged to greatly strengthen their efforts.

Turning to monetary and credit policies, I welcome the reductions in interest rates over the past few months, as it could help strengthen the economy. The Bank of Korea's commitment to remain flexible in implementing monetary policy in the period ahead is reassuring. It is also critical that viable firms be able to obtain adequate credit. In this regard, I share the staff's concern regarding the KDB scheme and endorse its termination by the end of this year. Korea Credit Guarantee Fund plays an important role in helping to finance the smaller and medium-sized firms.

On corporate restructuring, I note the progress made in many areas, as indicated by Mr. Callaghan's and Mr. Cho's preliminary statement. The reductions in corporate debt and in the interest coverage ratio of corporations are welcome. Nevertheless, it is clear that there are still substantial weaknesses in the corporate sector. In this regard, I welcome the passage of the corporate restructuring promotion law to help advance out-of-court settlements. This law, in combination with a unified and strengthened bankruptcy code, could go a long way in accelerating the needed restructuring.

Turning to the financial sector, the progress made in provisioning and reducing impaired loans is encouraging. However, further steps are needed in view of the continued risks stemming from weaknesses in the corporate sector. To this end, strengthening the supervisory process along the lines detailed in the staff report is advisable. It is also essential to advance the consolidation and restructuring in the banking sector. In this regard, the launching of the Woori Financial Holding Company and the nearly completed merger of the two commercial banks are steps in the right direction.

While I also welcome the planned reprivatization of the nationalized banks by the second half of next year, privatization at an earlier date will send a strong signal of the authorities' determination to speed up the restructuring process.

Finally, with regard to the external sector, exchange rate policy has been functioning satisfactorily. The sharp increase in reserves and the relative stability of the won add to the improved confidence in the economy.

With these remarks, I thank the staff for a well-written and focused report, and wish the authorities further success.

Mr. Joicey made the following statement:

As other Directors have noted, it is important to recognize how far Korea has come since the 1997 crisis and impressive progress made by the authorities in introducing sound economic policies and strengthening Korea's external position. We also need to recognize the significance of the changes that have emerged this year and the considerable uncertainties and vulnerabilities surrounding Korea's economic outlook. Korea has substantially reduced its external vulnerability. However, we think external development still poses a threat to its economic development.

The boom in the IT and electronics sector helped to underpin the rapid recovery after 1997, and the downturn has hit Korea and other countries in the region particularly hard. As other Directors have noted, exports have slowed significantly, with semiconductor and electronics exports falling sharply. The timing of any recovery remains unclear. Reports in Korea show that there is still widespread hope, but there is increasing pessimism over how soon the economy will recover. There may be impressive overhang in the IT sector, for the rate of IT appreciation and replacement may be much higher in the downturn than in the boom, and it may take considerable time for investment to recover. Clearly, we hope for the best outcome, but we wonder whether the staff has discussed with the authorities the consequences of a prolonged slowdown in the U.S. IT sector and potential new sources of demand. In this respect, we agree with Ms. Vtyurina's comments. What will be the correct policy response if the current downturn turns out to be long, unaccompanied by structural changes in the U.S. and global IT markets? This also relates to Ms. Lundsager's question on the relative merits of monetary easing as the best way to improve the economy.

Turning to monetary policy, for most of the last two years, the strength of the won has delivered price stability and bringing inflation under control. As other Directors have noted, inflation has picked up recently and appears likely that it will exceed the government target for 2001. We think the risks may be underestimated in the report. We note that unit wage cost growth has picked up, as output growth has slowed. There is some evidence of higher public service costs that may still be working their way through, and there is of course the risk of a further devaluation. While we understand why the staff is recommending easing at this point, we wonder whether at a time of high inflation there is a danger of distracting the central bank from its central objective of price stability.

We very much welcome the authorities' implementation of the new monetary framework, but its credibility still needs to be enhanced and, as Mr. Vittas and Ms. Manno, Mr. Yagi, and Ms. Lundsager have suggested, missing the target so soon after the creation of the framework may undermine the central bank's credibility. I would be grateful for the staff's views on whether the government should take action to improve the framework, for example, through amending the Bank of Korea Act in line with best practices. The authorities should attempt to strengthen their money market measures to enable the issue and use of treasury bills and the creation of a bank rate index. I would be grateful for the staff's views on whether this would indeed help to strengthen monetary policy and debt management, and promote the better functioning of capital markets.

At this stage of the discussion, let me comment briefly on a few other areas that are critical to Korea's outlook but have already been discussed and commented on in detail. First, we agree with other Directors on the need to improve the fiscal framework and the transparency of public spending. We agree that the heavily indebted public sector is the main risk. We would reiterate what has been said by Directors and in the staff report on the importance of strengthening corporate governance, addressing nonviable companies, and reducing state involvement in banks. We are concerned that the pace of reform appears to have slowed this year, at a time amid weak global demand when reform is essential to stimulate the private sector.

In terms of strengthening the financial sector and identifying vulnerabilities, we very much appreciate the authorities' intention to participate in the FSAP.

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

Let me first start with the questions on the growth forecast for 2001. Mr. Wei asked if the staff was too conservative regarding this forecast. Also, Ms. Vtyurina asked about our forecast for 2002, including on the current account sensitivity, and there was a related question from Mr. Joicey about the impact of a long-term downturn in the IT sector.

First, on Mr. Wei's question, I do not think the staff is too conservative about the 2001 growth forecast, as the forecast is actually based on an acceleration in growth during the course of the year. I think we need to remember that economic growth in the fourth quarter of last year was negative, while the first quarter of this year experienced slightly positive growth. Thus, to achieve a 3.5 percent growth for the year, the quarterly path goes from 0.3 percent growth in the first quarter to 0.9 percent in the second, to 1.5 percent in the third, and then finally to 1.9 percent in the fourth quarter. An acceleration in growth is assumed, and some of this acceleration may turn out, if anything, to be somewhat on the optimistic side, given what is happening in the global economy and judging from some of the more recent data on economic activity.

Regarding the staff's forecast for 2002, I think Ms. Vtyurina is certainly correct, and we will need to look at that forecast again. She asked specifically about the staff's current account forecast for next year, and certainly all the assumptions will have to be revisited. The scenarios that we presented in the medium-term projections are essentially based on the last World Economic Outlook (WEO) round. We are now going to be looking at these projections again in the context of the current WEO round. However, there is one thing I should mention regarding the current account forecast and its sensitivity to a global slowdown, and that is, in Korea we tend to see offsets. When exports slow down, imports also slow down, making it impossible to see the full impact on the current account. Currently, we are forecasting a current account surplus for next year as well, and even if there were a slowdown in world growth, I would actually expect that the surplus would continue.

On Mr. Joicey's question about the impact of a long-term downturn in the IT sector and whether this issue had been discussed with the authorities, the staff did not discuss this in the context of this mission, which was kept fairly focused. But, clearly, in the context of the forthcoming Article IV consultation discussions scheduled to take place in November 2001, this will need to be a central issue in our discussions. One small side note on this, I think it is important to remember that Korea is actually a much more diversified economy than many other countries in the region. There are a number of solid industries and exports of other commodities. Keeping in mind the global slowdown, the Korean economy is actually doing reasonably well.

There were several questions on monetary policy. Ms. Lundsager asked about the case for monetary easing, Mr. Hendrick asked about the inflation outlook, and Mr. Joicey asked about the further strengthening of the inflation targeting framework. Let me touch on these issues.

First, let me report some good news. The July inflation numbers were released today, and core inflation in July was zero relative to June. So, actually we are beginning to see a deceleration in core inflation, which is the basis for the setting of the inflation target. Core inflation, year-on-year, has now come down to 4.3 percent from 4.7 percent in May. Headline inflation is now down to 5 percent. I think we are beginning to see inflation coming down slightly faster than we expected, so we are quite pleased with this. Against that background, therefore, we certainly believe that, under current circumstances—specifically, a cyclical downturn and no major threat on inflation—monetary policy needs to be a part of the policy package to stimulate the economy.

The Bank of Korea has cut interest rates twice so far this year. The yield curve has flattened, and, to some extent, the low interest rates are contributing to the recent pickup in construction activity, and supporting consumer demand and equity prices. I should also note that low interest rates are making it easier for healthy corporations to refinance and to lower their cost of investment. Again, as a side note, I think it is important not to paint the Korean corporate sector with too broad a brush. There are, indeed, a number of healthy and competitive corporations in Korea that could benefit from an easier access to credit with easing monetary conditions.

That being said, I would certainly agree with the central premise of Ms. Lundsager's question, which is to have a sustainable recovery and to boost long-term growth. Corporate restructuring and sectoral changes in general are indeed critical. Therefore, I would fully agree that monetary policy in and of itself is at best just a short-term palliative. There is no choice but to continue with the restructuring.

I think another point that Ms. Lundsager implied is also correct, that low interest rates and easy liquidity conditions certainly run the risk of prolonging the exit of nonviable firms and reduce the incentives for restructuring firms. I think, at the same time, it is important that the Bank of Korea should not keep monetary policy any tighter than necessary just to promote corporate restructuring. The incentives for restructuring will need to come from elsewhere.

A subpart of the question was on SMEs' access to credit. I am pleased to report that SMEs are indeed getting more credit than in the past, and the reason is basically that, with the large exposure limits and concentration limits imposed on banks, banks have actually had to go out and seek SMEs as borrowers.

On strengthening the inflation targeting framework, the issues are pretty much the same as those discussed earlier in the last consultation. That is, more needs to be done in terms of public communication about the target and the setting of the target—an annual target versus a medium-term target. We really have nothing new to add on that.

Mr. Joicey also asked some specific questions regarding the money market, and I will discuss that with him bilaterally.

Mr. Hendrick asked if the staff was confident that inflation would remain around 5 percent for the whole year, considering that, as mentioned by Ms. Lundsager, real interest rates were already low.

The staff representative from the Asia and Pacific Department (Mr. Chopra) replied that headline inflation was currently at 5 percent and on a downward trend, while core inflation, which was the focus of the inflation targeting regime, was 4.3 percent and also on a downward trend on a year-on-year basis. Thus the staff's view that it was still likely that the central bank's inflation target range might be exceeded, though marginally and by less than the amount envisaged earlier. In that regard, the assessment in the staff report was still valid.

On fiscal policy, there were questions regarding the functioning of automatic stabilizers, the implementation of the supplementary budget, and the effectiveness and timeliness of fiscal stimulus, the staff representative noted. As elaborated in the staff report, the fundamental problems in implementing fiscal policy were of a medium-term nature, related to the forecasting of budget aggregates, intra-year budget monitoring, medium-term expenditure plans, and the concept of central government versus general government. The staff was concerned that fiscal plans, either in the original budget or in the supplementary budget, would be very difficult to achieve under current circumstances. There was a serious danger that both the fiscal deficit target of 0.2 percent of GDP—which was the target before the supplementary budget—and the target implied in the supplementary budget might not be achieved. A large part of the supplementary budget comprised transfers from the central government to the provinces, which would increase the central government's deficit, but the provinces might not be able to spend them, and hence the expected fiscal expansion might not be realized on a general government basis. That was one of the medium-term issues that needed to be addressed. Moreover, automatic stabilizers in Korea were rather weak. The staff would discuss some of the specifics in that area with Mr. Jonáš bilaterally.

With regard to government guarantees, there were two primary guarantee mechanisms in Korea—traditional public guarantee funds and corporate bond guarantees—the staff representative continued. The two existing public guarantee funds—Korea Credit Guarantee Fund (KCGF) and Korea Technology Guarantee Fund (KTGF)—operated like other institutions with similar objectives in both OECD and non-OECD countries. Their primary function was to provide loans to promising enterprises, many of which were SMEs that typically lacked collateral to obtain funds from commercial banks. As of April 2001, the KCGF had provided total guarantees accounting for slightly below 5 percent of GDP. Loans extended by the KTGF were relatively smaller. The staff had projected the issuance of government guarantees for bond rollovers in 2001 to reach about W17.1 trillion, equivalent to 3 percent of GDP—the figure that Ms. Lundsager had cited in her intervention. However, as conditions in the bond market had turned out to be better than expected, it was likely that the actual use of these guarantees could be substantially less.

The second type of guarantee mechanism—corporate bond guarantee—was provided through the Seoul Guarantee Insurance Fund, which had been created by merging two previous institutions that had provided bond guarantees prior to the crisis, the staff representative explained. Its principal role had been to take over the Daewoo bonds, which required a substantial recapitalization from the government.

At present, guarantees provided by those public funds were only partial, consistent with the obligations under the Stand-By Arrangement, which required the government guarantee funds to move away from full to partial guarantees, the staff representative noted. That was considered an important policy measure to build a credit assessment culture.

Mr. Baukol wondered what the size of the total guarantees was in 2001, compared to that in 2000, and what the staff's projection would be for 2002. It appeared that the size of the guarantees for 2001 could amount to at least at 5 percent of GDP.

The staff representative from the Asia and Pacific Department (Mr. Chopra) responded that the traditional guarantees extended by the KCGF and KTGF had not grown much, especially since the move to the system of partial guarantees. The staff would provide more specific details at a later date.

On bank ownership limits, Korea currently had a 4 percent limit on the ownership of bank shares by domestic residents, the staff representative said. There was no limit on foreign ownership of banks, but investment in Korean banks by foreign entities required approval of the financial supervisory agency. The 4 percent limit had been put in place to keep the chaebol out of the banking business, and in the past it had proved effective, as Daewoo Corporation had not been able to expand its business into the banking sector. The existing policy, however, was perceived by the Korean people as discriminatory against residents, and had led to a debate about ownership limits. Looking forward, it would be appropriate for the authorities to carefully reconsider that rule. On the one hand, based on international experience, most countries did not have such limits, but on the other hand, supervision would need to be sufficiently strong to ensure that no conflicts of interests would arise if a nonfinancial company owned a bank, that a bank looked after the interests of depositors first, and that the company stood ready to provide capital beyond its limited liabilities if needed.

With respect to Mr. Hendrick's question about the out-of-court workout process and the court system, out-of-court debt workouts were normally faster and more cost efficient than the court-supervised insolvency procedures, as the former basically involved negotiations between creditors and debtors to come to an agreement on the basis of their own commercial interests and the insolvency framework, the staff representative commented. The court-supervised workout process, on the other hand, involved legislation, including rules and valuation of assets, thus removing the flexibility that debtors and creditors had outside the court. The length of time for the resolution of insolvency cases could vary from six months for relatively straightforward cases to two years for very complex cases. That was one of the reasons why pre-packaged bankruptcy was preferable and had been put in place. Another important element to help accelerate debt restructuring was "cram down" provisions, which would make a corporate rescue plan binding on dissenting creditors. It remained to be seen whether the time frame would indeed be reduced.

Regarding Ms. Vtyrina's question on the partial deposit insurance scheme, a deposit insurance law that had been introduced prior to the crisis had limited guarantees for bank deposits to W20 million per depositor, the staff representative related. Subsequently during the crisis, the government had provided a blanket guarantee, which, in accordance with the Stand-By Arrangement had to be replaced by a partial insurance system. On January 1, 2001, a partial deposit insurance system had been reintroduced, with the W50 million ceiling for individual deposits chosen on the basis of international comparisons of GDP. The authorities had also been concerned that the switch from a full guarantee to the original W20 trillion per depositor would be too drastic. In the second half of 2000, there had been some modest movement of deposits to financially stronger banks, but no major movement had been observed since the shift to the partial guarantee system.

On Mrs. Mateos y Lago's questions regarding the pace of financial and corporate restructuring and the risk of reversal, Korea had achieved tremendous progress—to such an extent that one would have expected under the most optimistic scenario—the staff representative acknowledged. Three to four years ago, no one would have expected that the reforms in Korea would have gone that far. The major change was on market discipline, currently playing a much stronger role in Korea than in the past, and that would not be easily reversible. At the same time it could be argued that while most of the easier tasks had been completed, more difficult reforms remained to be tackled. Metaphorically speaking, the hardware reform had largely been achieved, while the more difficult, time-consuming software reform still needed to be carried out to ensure the sustained implementation of rules and principles. A part of the hardware reform that remained to be addressed further would be the insolvency system, as the two reforms of the insolvency system in the past three years had yet to achieve the intended objectives. Meanwhile, the software reform required changes in the business culture and operations.

Mr. von Kleist made the following statement:

> At this point in the discussion and since I am in broad agreement with the staff document, I shall only mention three points for emphasis.
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> We are glad to note that Korea's capability to repay the Fund is secured; however, risks seem to be rising.
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> The staff recommends, and we agree, that the government should show a clear commitment that it would allow the exchange rate, stock prices, and other financial prices to absorb some of the expected pressures. The authorities should make it clear that they are not willing to bail out anybody or any company no matter how large they are. Otherwise, the risk of a sharp deterioration of market sentiment is going to increase. In this context I would like to commend the authorities for having refrained from exchange rate interventions since our last discussion. We hope that the authorities stick to their self-chosen policy of a flexible exchange rate system also in the future.
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> We would also like to endorse the staff's recommendation to sell the government's stakes in financial institutions. Although Mr. Callaghan and Mr. Cho are right when they point out that ownership does not equal management, the best way to separate conflicting interests is the privatization of state-owned banks. We should not forget that there is a long history of political influence on banks, a policy that was in part responsible for the financial crisis in 1997.

Finally, we would like to encourage the Korean authorities to continue to stay focused on, and to proceed further with their ambitious reform agenda. Although a successful implementation is more difficult in an economically weak environment, such an environment paradoxically seems to be more supportive with regard to the willingness to push through an ambitious reform agenda.

Mr. Kpetigo made the following statement:

The Fund-supported program has helped in sustaining the growth momentum of the Korean economy and external vulnerability has been sharply reduced. However, corporate sector weaknesses continue to pose problems to the financial sector and it is unfortunate to note that the recent global slowdown has started to affect negatively the strong growth of the economy. But, we are encouraged by the low probability of a balance of payments crisis.

As Mr. Daïri pointed it out in his preliminary statement, thanks to the many achievements since 1997 the Korean economic growth has been strong enough to weather the deterioration of the external environment created by the global slowdown. In this context, we agree with the staff that the authorities should clearly ease both the monetary and fiscal policy to reverse the economic downturn. We welcome the efforts already made by the authorities in the monetary area and we are of the view that more could be done. On the fiscal front the large fiscal surplus accumulated during the first quarter of 2001 gives a room of maneuver for the authorities to increase spending that could boost consumption and production activity.

The overall external situation continues to be favorable and domestic financial markets remain calm, as evidenced by sound fiscal position and low inflation. However, the restructuring of corporate and financial sectors have incurred significant delays that could further worsen the economic vulnerability if not addressed steadfastly. Efforts have been made to put the economy on more solid path. As I have already said, stronger measures are needed to restore domestic demand and growth through focus on the restructuring agenda and fiscal stimulus. In this respect the supplementary budget needs stimulus along with further easing monetary policy to contain economic downturn. With respect to structural reforms, the recent reduction of the government's stake in Korean Telecom after international sale of shares is welcome. We encourage the authorities to adopt a similar stance in the rest of the corporate sector so as to contain further weakening in growth prospects for 2001.

We agree with the staff and other speakers on the need of contingency plans along with the appointment of a court receiver. At the same time further efforts should be devoted to the reforms of the insolvency systems. We also agree with the importance to achieve an amendment of the bankruptcy law to make sure that the reforms process will not suffer from judicial obstacles.

With these remarks, we wish the authorities every success.

Mr. González Sánchez made the following statement:

First of all, we thank the staff for the candid and informative report and Mr. Callaghan and Mr. Cho for their comprehensive preliminary statement. Like other Directors, we commend the authorities for their reform and stabilization efforts, which have made the Korean economy stronger than before the 1997 crisis. The fact that in spite of recent tension in some other emerging markets, Korean financial markets have remained stable and calm, shows that the reform and stabilization efforts have paid off, and that market participants differentiate appropriately among emerging markets.

It is reassuring that the authorities are committed to the task of addressing the continuing weakness in the corporate and financial sectors, and that there has been substantial progress in the high profile cases of corporate restructuring. We are pleased that the authorities intend to reach a point in the restructuring process where there can be no turning-back before the elections next year. In spite of the progress achieved, economic activity in Korea remains weak, indicators show a mixed picture, and the external environment is difficult.

In this framework, we consider that the response of the authorities has been appropriate. We find Mr. Callaghan's and Mr. Cho's arguments that their authorities are providing adequate stimulus convincing. Particularly encouraging is the fact that unemployment has reached its lowest level for three years with no evidence of demand pressures, considering that, as we know, the recent pick up in prices has reflected temporary factors (increases in public sector charges and the depreciation in the currency).

We welcome the authorities' intention to accommodate a consolidated fiscal deficit of up to 1 percent of GDP in 2001, as well as the supplementary budget submitted recently to the National Assembly (equivalent to 0.9 percent of GDP). We also welcome other actions such as the expansion of capital investment and spending ahead of schedule by some state-run enterprises. It is encouraging that the authorities are considering the best way to address recent recommendations on technical assistance by the FAD, thus addressing the staff's concerns on the need for a fundamental reorientation of budget practices. On monetary policy, we welcome the authorities' recent movement in July to further lowering interest rates.

According to the staff, the large government presence in the financial sector has made corporate restructuring difficult, given the roles of the government as supervisor and as a major shareholder in banks with large corporate exposure. Here we are pleased by Mr. Callaghan's and Mr. Cho's indication that even during the inevitable period of state ownership, a clear distinction was made between ownership and management, thus avoiding conflicts of interests. At any rate, we consider that the possibility that this situation might produce moral hazard makes the reprivatization of nationalized financial institutions a priority.

We share Mr. Callaghan's and Mr. Cho's views regarding the possibility of an over-reaction by the market with respect to the staff's analysis in Box 2, and like Ms. Vtyurina, we consider that the assumptions behind said analysis are limited and it would be better to wait for the more complete analysis of the FSAP review.

Finally, we commend the Korean authorities for the process of repurchases aimed at eliminating all Fund outstanding credit by end-August 2001. We look forward to the FSAP assessment on the Korean financial system, and we wish the authorities every success in their endeavors.

Mr. Jadhav made the following statement:

We fully endorse Mr. Chopra's assessment that the Korean economy has achieved an impressive turnaround since the 1997 crisis. The achievements of the Korean economy are far too many to recount, near double-digit growth rates in 1999-2000, low inflation rate, a fall in unemployment rate, the return to a fiscal surplus in 2000, and a strong external sector. These notable achievements emanated in no small measurement from the commitment, ownership, and implementation of a wide range of reform measures for which the Korean authorities deserve to be complimented.

Notwithstanding this exemplary performance, we agree with the staff assessment that there is still a large unfinished agenda. The reform process has now reached a more difficult and painful phase, and a lagging reform effort can jeopardize the gains made so far. The recent slowdown of the economy indeed calls for a fresh impetus to reform. Having returned to a fiscal surplus in 2000, it is clear that the authorities should not seek to repeat the fiscal performance in 2001. Given the recent slowdown of growth, better intra-year monitoring will be necessary, so as to insure that the budget is not pro-cyclical.

On monetary policy, while the need for establishing credibility in the inflation targeting framework is undeniable, we do not agree with the staff assessment that there is a call for the easing of monetary conditions. We feel that there is a strong case for a bias toward a modest further easing so that both monetary and fiscal policies are geared toward easing activity. This is further strengthened by the latest information provided by Mr. Chopra regarding zero core inflation in July.

On the structural side, we wish to underscore the importance of continued reform, especially in the corporate and financial sectors. The corporate sector's profitability is still low and remains highly leveraged, with corporate debt still accounting for more than 100 percent of GDP. As noted by Mr. Shaalan, the large corporate debt problem poses substantial risk to the soundness of the financial sector, especially if the economic slowdown is prolonged. In this regard, the proposed reforms are likely to pose a major challenge, given the sensitivities associated with the forthcoming local elections. A discernible progress on corporate restructuring and restoring financial sector soundness will be needed so as to preserve the momentum gained so far. Given the excellent track record of the Korean authorities, we certainly hope that such reform efforts would be preserved in the interest of high medium-term growth and for reducing vulnerability to shifts in market sentiment.

With these remarks, we wish the Korean authorities every success in their policy endeavors.

Mr. Munthali made the following statement:

Korea has come a long way with its economic adjustment and structural reforms since the crisis of 1997. We are pleased to note that the authorities have persevered with these often painful reforms and, the crisis which almost unraveled the very foundations of society, is now firmly behind us. Even when faced with a weak global economic environment and, despite continued vulnerabilities in the corporate and financial sectors, Korea seems to be in a better position to withstand the risks associated with the weakening external environment. The major restructuring of the economy and the strengthening of economic structures has undoubtedly helped to boost consumer confidence and to revive domestic capital markets.

Nevertheless, the current weakening of the external environment has brought into sharper focus the need for the authorities to stay the course in their economic adjustment and reform. To this end, we have been reassured by Mr. Callahan and Mr. Cho, in their very insightful preliminary statement, that the Korean authorities are not being complacent behind the enormous achievements since the crisis emerged in 1997. Instead, the current situation has increased their resolve to press ahead with the remainder of the reform agenda, especially in addressing the weakness in the corporate and financial sectors. We would also encourage the authorities to continue pursuing prudent macroeconomic policies in order to increase the resilience of the economy and ward off potential shocks.

The current economic situation shows mixed results: domestic demand remains somewhat sluggish, reflecting the downturn in industrial production, especially in the semiconductor sector, which has been affected by the weakness in external demand. Unemployment is reported to be the lowest in three years since the onset of the crisis. Inflation has picked up somewhat due in part to the increases in public sector wages and the depreciation of the currency. In the light of all this the authorities now expect a slightly lower growth than originally anticipated.

It is against this backdrop that the staff has advised that macroeconomic policies in 2001 should support growth by easing fiscal and monetary policies. We certainly agree that there is scope for loosening policy conditions in these areas. Indeed, the main challenge facing the Korean economy is slow growth and we note that in the context of the supplementary budget the authorities will accelerate spending, while heeding the staff advice on the need for front-loading of expenditure. It is still unclear whether or not the authorities have started to incorporate some of the recommendations of the FAD technical assistance report in the supplementary budget. In any event, the measures proposed are long term in nature for which careful preparation will be important.

We also note that monetary policy is being adjusted to support growth in the context of the inflation targeting, taking into account the fact that the recent up tick in inflation is mainly due to temporary, exogenous factors since demand and wage pressures remain insignificant. We see merit in the cautious easing of monetary conditions, which should not jeopardize the relative stability of the exchange rate. Meanwhile, we continue to be encouraged by the restructuring of the financial sector, involving the consolidation of insolvent institutions and the injection of additional capital. We join others in urging the authorities to press ahead with these reforms in order to reinforce the ability of the financial sector to better withstand future crises. The idea of completing these restructuring efforts ahead of the election cycle is to be commended.

As regards corporate restructuring, while accepting that considerable progress has been made in this area as evidenced by the rebound in bond and equity markets, it is important that the authorities should move decisively in dealing with distressed companies, including the Hyundai affiliates. The authorities are well advised to avoid temporary solutions that may prove more costly to resolve at a later stage. Accordingly, it will be important for the authorities to amend the bankruptcy law and to introduce improvements to the court-supervised insolvency regime. Moreover, the privatization of state enterprises and the sale of government stake in the troubled companies would enhance corporate restructuring.

Finally, although Korea was discussed only some months ago under the Article IV consultation process, this post program monitoring has been useful in bringing into focus the challenges facing the economy. In this connection, the preparation of the supplementary budget should be considered as an important, robust response to the changing economic circumstances. We wish the authorities continued success in the management of their economy.

Mr. Yakusha made the following statement:

I would like to express our appreciation for the staff report and supplementary statement. I would like to note that the tone and the mood of both the staff report and the statement are somewhat different, which would probably reflect a mixed picture on the ground. Our views are very similar to those expressed by Mr. Vittas and Ms. Manno in their preliminary statement. Following their logic of short term versus medium term, we are not completely comfortable with the idea that basically short-term domestic demand management on the monetary and fiscal sides would have a lasting effect on growth recovery if the slowdown in growth is indeed caused by the global demand factor and related factors. So, we consider that longer-term credibility issues could be of more importance than short-term temporary solutions. Those short-term solutions are even less appropriate in the structural reform area. In this respect, we would like to hear staff comments, if any, on today's news report that the government is moving to relax controls over the 30 largest business groups.

We have sympathy with the authorities' request to delete Box 2 on the grounds of market sensitivity, but we would like to specify that we would be reluctant to endorse this deletion on any other grounds. So, we would like to hear the views from the Policy Development and Review Department, if possible, whether the information in Box 2 could be considered market sensitive.

The Acting Chairman (Mr. Fischer) suggested that the staff representative should respond on the news report mentioned by Mr. Yakusha bilaterally after a chance to carefully check the fact.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael) noted that the deletion policy allowed the deletion of specific sentences that were market sensitive, or the data that conveyed a message that was important and sensitive to the market. However, to delete a whole section—including other related components—that were not market sensitive would go beyond the usual rules and practice and would set a precedent of removing a whole section on the grounds that some of the contents in that section could pose problems. The staff would thus be reluctant to recommend approval of that request. It was the staff's understanding that a request for the deletion of Box 2 of the staff report had been made by the U.S. chair, not by the authorities. The staff would not consider that request unless it was made by the authorities.

Mr. Baukol clarified that, contrary to the staff's understanding, his chair supported the publication of Box 2, as it showed that the banking sector was not that vulnerable, even in some negative scenarios. The publication of that information should be of benefit to the country.

The Acting Chairman (Mr. Fischer) thanked Mr. Baukol and asked if Mr. Callaghan would comment on that matter.

Mr. Callaghan made the following concluding statement:

> I think at the outset I would like to thank all the Directors who have made their statements and the contributions in their preliminary statements. A lot of very pertinent points have been raised and some very relevant comments. One thing I should record at the very start is the priority that Korea has placed on this whole exercise, on this PPM review. They do take it very seriously and put a high weight on it. They see a lot of value in the mission and in this discussion and the views will be faithfully reported. This is something that I have certainly been struck by, the priority Korea places on this exercise. But it is very much in keeping, I think, with the importance that Korea does place, and also the Korean public places, on the views of the Fund, and again I could not overemphasize this, and I think you, Mr. Chairman, have had firsthand experience in terms of the emphasis that is placed on any statement you make that gets public reporting in Korea.
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> I would at the start certainly like to record great appreciation from my Korean authorities for Mr. Chopra and his team. They certainly have been extremely professional, very constructive, and have made an important contribution to the development of public policy in Korea, and Korea did try to get as much as they could out of the mission and the opportunity to have such discussions. In addition, my authorities would, in particular, like to extend their thanks to you, Mr. Chairman, for you have played a very important and instrumental role in this process and Korea's recovery from the crisis. It has been an irreplaceable contribution.
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> The discussion today has been very interesting, and most of the issues raised have been covered in the very fulsome replies by Mr. Chopra. I think there are just a few points I would like to make, a few observations. One of them is the point that Mr. Chopra has just made, which I think is a very important one. It has come through in a number of Directors' comments about the importance of recognizing the success of the achievements that have been made. I think that we always have a tendency to focus on what has to be done and are sometimes forgetting what has been achieved, but I think Mr. Chopra

made a very important point about not painting Korea with too broad a brush, and I think that is sometimes a problem. You can generalize too much in some comments. As I go on, I think there were some interesting things that came out of the discussion, but first up in terms of the outlook for this year, in the contributions of macroeconomic policy, I think it is worthwhile to recall that Korea, just like so many other countries, particularly in the Asian region, is being buffeted by what is happening in the world economy and by the downturn in the United States. If we just recall last Friday at the U.S. Article IV consultation discussion, Ms. Lundsager made the comment that when looking at the United States, it also means we are looking at the rest of the world because of the implications of developments in the United States on other economies. Here is a real case in point. I think that some of the sentiments that have been expressed today may well be a little bit different if we had seen a stronger world picture in terms of the environment or the background in which Korea has to make its structural adjustments. Now, this is no reason for saying that the priority for going ahead with structural reform has in any way changed, in fact I think it is enhanced. But it is important to remember what are some of the background influences on the environment in which the reforms are being undertaken and what is coming from the external side is particularly important.

As outlined in the preliminary statement, and there has been a little bit of a discussion of this, involving differences on the short-term outlook for the economy. Yes, the authorities are a bit more optimistic than the staff, although certainly we would have to acknowledge that there is a great deal of uncertainty as to the outlook and a lot of that uncertainty comes from the world economic outlook. Now, Directors have focused on the importance of support from macroeconomic policies. We certainly agree that macroeconomic policies are playing their role, and I know Directors have called for this and I think the fact that there is this support for macroeconomic policies is one of the factors why the authorities are a bit more optimistic than staff in terms of the short-term outlook.

Fiscal policy will be playing a stimulatory role in the second half of this year. There has been some discussion and concern that not all the budgeted amounts were spent in the first half of the year. Will they be able to spend all the budgeted amounts, including the supplementary budget in the second half of the year? One thing we know is that we are going to have a more stimulatory fiscal policy in the second half of the year, and it is probably going to be coming just at a time when you want to be supporting activity.

In terms of the ability to spend the budgeted amount, and Mr. Chopra commented on this, in the supplementary budget, about 90 percent of additional expenditure will be through the provinces, and there is a mixture of current and capital spending, but they have already factored in a lot of the supplementary budget in capital plans. In many respects, many of the lead times will be reduced, so there is a good prospect that we are going to see a substantial amount of that being spent, and it will be providing a stimulus.

On monetary policy, there has been a bit of a change since the staff paper was written, and the supplementary statement by the staff has picked up a number of the things that have changed since the staff report, and monetary policy is one of those. In the staff report, the mission was saying that Korea probably needed more interest rate reductions and there should be a bias toward easing. Since then, we have seen another reduction in interest rates. It is interesting, though, that this is an area where there has been a little bit of diversity of views in terms of the scope for further reductions, and certainly when the Governor of the Bank of Korea announced the second reduction in interest rates recently, the markets interpreted that as a bias toward further easing, because he emphasized the slowdown in activity and the pressure coming off prices. But, as I say, it is interesting that there is this diversity of views expressed today. Now I would just make a comment that whenever you have some difference of views on the operation of monetary policy, namely, a change in interest rates, it is a pretty good sign because it usually means that monetary policy is not operated too badly, for if there were overwhelming views one way or the other that there should be a change in monetary policy, that is usually a bad sign because it probably means that any such move is too late. In that respect, I think we can take some comfort in the diversity of views. Mr. Joicey raised a concern about taking the eye off inflation and maintaining low inflation. The one thing I know for certain is that the Governor is extremely focused on maintaining low inflation in the inflation targeting regime. In terms of the issue that was raised about the contribution of monetary policy versus structural reform, and would reducing interest rates be making it too easy for firms to obtain finance and unviable firms would stay on where they really should be leaving the marketplace, I thought Mr. Chopra's comments really hit the nail on the head here. Certainly structural reform has to have priority, but again monetary policy should play its role, focused very much on trying to allow the economy to grow as fast as it can without inflation, without inflationary pressures breaking out and inflation targets being broken. I think in that sense the Governor is very clear on what his objectives and responsibilities are.

On this whole question of the pace of corporate and financial restructuring, again, I think Mr. Hendrick picked up a point there, if I heard him right, of saying that he thought there were only small differences between the authorities and staff. I do not think there is a significant difference here at all. It is a common theme to say yes, the task is not complete and we urge the authorities to continue with this task. The authorities would absolutely agree 100 percent. I think there is no question of the priority they place on continuing with the reforms. Again in that regard, I think Mr. Chopra made a very important point about the need to focus on what has been achieved and note that really Korea is probably in front of where we thought it would be even on the most optimistic scenarios. Now, certainly the country is not alone in having to address the consequences of the financial crisis. From 1997 onward, Korea has had to face a very large NPL problem in the banking sector and high levels of corporate debt, and having to unwind this is no easy task. But, if one looks at the progress that Korea has made and compares it with the progress other countries have made in addressing similar problems, I think one would say that Korea has achieved a great deal. The other important point that Mr. Chopra made was that Korea is moving into some of the hard parts of the process of corporate reform. Remembering that is important in terms of this impressions that people have about the pace: is it slowing? I do not think it is slowing at all really. It is a case of always having to be realistic about the complexity of the task that is there. We have to get the fundamentals right, put the hardware in place and, as Mr. Chopra said, pushing on ahead becomes increasingly harder. We have to remember the complexity of the task. I think Mr. Wei picked this point up.

In terms of corporate restructuring, there have been some comments on some particular companies, and again there is progress. We are seeing moves toward restructuring in Hyundai Engineering, Hynix, and Daewoo. The process is not complete, but the moves are truly underway. The one point I would make with this, and it has come up a few times, I think Ms. Lundsager in particular raised this concern, namely, who is taking the decision about putting money into these troubled firms. Related to this is the question whether there is a conflict between the government as owner of banks and the banks taking decisions on the troubled firms. I think it is important that in this restructuring it is the decision of the creditor banks. In terms of the conflict between commercial decisions and government ownership of the banking system, I think we have always got to remember that government ownership of banks was an inevitable fallout of a financial crisis, and we have seen it in every country that has had a financial crisis. Then we have to work our way through it. Commercial decisions still have to be taken, and Korea has been at pains to separate government ownership from management, and I think they would emphasize that these decisions have been taken by the creditor banks. It has been the banks'commercial decision that, for the troubled firms, by reducing the debt burden through debt equity swaps, for example, as in the case of HEC, the firms may have a good chance of being able to work their way out and this would be the most commercially viable decision for the creditor.

On the restructuring of the financial sector, it is very easy to say, yes, we should move faster in reprivatizing the banking sector. The authorities have put a strong priority on that, but, again, it is always harder to do than actually say, but we are seeing progress. As we have noted, Seoul Bank is negotiating for equity participation with a foreign partner. It is interesting that Mr. Yagi noted that really we should perhaps wait until the market improves. I think it shows there is a diversity of views and it is going to be a complex task.

On the whole question of the guarantee schemes and what is happening there, again, I think it is important that we take one step back and realize that the KDB underwriting scheme was introduced to handle a real contingent problem, and that was a breakdown in the whole corporate bond market. It was an emergency arrangement. The emergency has not occurred; we have seen the corporate bond market starting to recover better than was hoped. In many respects, the underwriting scheme has been successful, it has achieved its objectives, and it will be terminated by the end of 2001.

On the question about the overall level of the contingent liabilities on the government through the guarantee scheme, I would just add to the comment that Mr. Chopra made. He noted that for many of the traditional guarantee schemes, the overall level of liabilities has probably been reduced. If we just look at one case in point, the Seoul Guarantee Scheme, the total amount of the guarantee borne by the Seoul Guarantee Scheme was W140.1 trillion when two previous guarantee companies were merged. That was back a few years. If we look at what the total level of those liabilities now, it is W60.1 trillion, so we are in the right direction.

On the insolvency system, yes, I think the authorities certainly put the highest weight on the need to speed up that process. There has been legislation to give a legal basis to the out-of-court workout procedure. There were concerns, and I think the staff raised concerns, that this would diminish the need to improve the court-supervised arrangement. It has had the opposite. It has put the pressure on and it has resulted in a faster process in moving with the court insolvency scheme. A task force will be reporting by the end of this year on the court insolvency system. Mr. Daïri in his preliminary statement picked up an important point, namely, that this is a very big undertaking, so it is one of these things that are easy to say, but getting on to do it is that much harder.

Finally, on the question of the publication of the report, Korea very much respects the policy on transparency, but as I mentioned, the views of the IMF in the Korean domestic scene have an enormous weight. The publication of the report in the current environment is more likely to see it politicized, and the result can, rather than helping the process of restructuring, hinder the process if these views and this whole process become political issues. So, on that basis, the authorities are not going to publish the report, but to repeat, they do put very high weight on this whole exercise and are appreciative of the role the Fund has played.

The Acting Chairman (Mr. Fischer) thanked Mr. Callaghan for a comprehensive report, and the authorities for their kind words. It was true that Korea's restructuring had moved at an impressively remarkable speed, and that one had to compare it with the speed at which various industrialized countries with banking sector problems had operated at different times. He noted that many Executive Directors, including Mr. Callaghan, had commended the staff for the quality of their work on Korea.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the reorientation and strengthening of the structure of the economy since the 1997 crisis, and noted that external vulnerability has been sharply reduced. The weak global economy, however, has taken a toll on Korea, while domestic demand remains sluggish. In light of this, Directors welcomed the authorities' recent steps to ease macroeconomic policies, but they also stressed the need for firm action to address the continued weaknesses in the corporate and financial sectors, in order to maintain confidence in the restructuring effort and increase the sustainable growth rate.

In view of the slowdown, Directors noted, in particular, that it will be important to achieve the desired degree of fiscal stimulus in 2001, and urged the authorities to work toward meeting the revised target for the consolidated central government deficit. More generally, Directors noted that a fundamental reorientation of budget practices will be necessary to address the shortcomings in the implementation of fiscal policy, and, in this regard, they welcomed the authorities' consideration to implementing the recommendations of the Fund's recent technical assistance report.

Directors observed that monetary policy has so far succeeded both in building credibility in the inflation targeting framework and in responding to the economic downturn. They noted that the recent increase in inflation is largely due to temporary or exogenous factors, that weak economic activity has kept demand and wage pressures down, and that the most recent inflation data suggest that any breach in the inflation target this year will be small. In view of these conditions, Directors endorsed the Bank of Korea's recent decision to lower its overnight call rate target, and generally supported the use of the scope for some further easing, if necessary. However, they noted that such easing would have to be well explained to the public so as to ensure that progress toward establishing the credibility of the inflation targeting framework remains intact. Directors also welcomed the flexibility in the exchange rate and the decline in the frequency of foreign exchange market interventions. They also reiterated that intervention should be limited to instances where trading is exceptionally disorderly.

On the corporate front, Directors expressed concern that large distressed companies and the presence of nonviable firms continue to be a drag on the economy and a source of vulnerability. They observed that the successful resolution of these and any new cases of financial distress will reduce vulnerability and help boost market confidence. Directors stressed that the resolution of these cases is largely a matter for creditors and investors, and that it would be important that the government not intervene and not provide support to nonviable companies. They cautioned that temporary solutions, such as an increase in government guarantees of corporate bonds, or further delays in addressing corporate weaknesses could create larger problems that will prove more difficult and costly to resolve later. Directors therefore welcomed the authorities' intention to terminate the Korea Development Bank corporate bond underwriting scheme by end-2001.

Directors highlighted further insolvency reform as essential for accelerating needed restructuring. Although the voluntary out-of-court workout process should remain an avenue for restructuring, they noted that weaknesses in the insolvency framework have held up agreement on workout programs and delayed the sale of some distressed assets. Directors therefore considered strengthening of the bankruptcy law—including giving greater power to senior creditors—to be a high priority, and urged the authorities to move quickly to prepare the necessary amendments. They also noted that, although corporate governance has improved in Korea, it remains important for the authorities to press ahead with further improvements to bring it up to international best practices.

Directors noted that much progress has been made in restructuring the financial sector, but that problems remain largely as a result of continuing weaknesses in the corporate sector. They expressed concern that the role of the government as part-owner and supervisor of financial institutions, coupled with a significant role as a guarantor of corporate debt, would hinder the pace of restructuring and risk impeding the development of a sound commercial banking system and a thriving capital market. Directors therefore welcomed the authorities' intention to reprivatize nationalized financial institutions and noted that such action would help accelerate corporate reform. They urged the authorities to carry out the planned privatization of Seoul Bank and to accelerate the privatization of other bank holdings. The need for further strengthening of the operational capacity and risk management of banks was also highlighted.

Directors welcomed the forthcoming Financial Sector Assessment Program, which should help to assess the progress made both in restructuring the financial sector and strengthening the supervisory process over the last three years, and in identifying the remaining shortcomings.

Finally, Directors welcomed the early repurchases made by Korea to the Fund, noting that all Fund credit outstanding would be repaid by the end of August 2001. Directors urged the government to continue their steadfast pursuit of the remaining restructuring and reform agenda, which will contribute to an economy that is stronger, more flexible, and less vulnerable to a financial crisis, as well as help ensure higher medium-term growth.

2. THE BAHAMAS—2001 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 2001 Article IV consultation with The Bahamas (SM/01/230, 7/17/01; and Cor. 1, 7/31/01), together with a statistical appendix for The Bahamas (SM/01/231, 7/17/01).

Mr. Bernes submitted the following statement:

My Bahamian authorities would like to express their sincere appreciation to the staff for another constructive consultation. The comprehensive and detailed discussions with the staff are a significant input to their policy deliberations and decisions.

Background

The current government was elected in August 1992 and re-elected in March 1997. When this government came into office, macroeconomic stability was slipping away. In 1991, real GDP contracted by 2.7 percent, consumer prices rose by 7.1 percent, the central government deficit was 3.4 percent of GDP, and net international reserve cover of the monetary base was down to 84 percent. The government immediately set to work to restore macroeconomic stability in a gradual, but steadfast manner. They brought the current balance of the central government into surplus, while increasing the proportion of spending allocated to health care and education. And they established low, stable inflation. The pursuit of sound policies restored confidence in the economy which in turn resulted in a private-sector-led recovery. The recovery began gradually, then built to very strong growth in 1999 and 2000. Unemployment has declined significantly, and there has been a notable improvement in social indicators more generally.

Presently, the tourism sector accounts for about half of the economy, with the financial sector accounting for 15 percent and public administration, 10 percent.

Recent Developments

The Economy

With slower growth in the United States and the recent completion of several major investment projects, the pace of economic activity in The Bahamas is expected to decelerate this year, but to remain reasonably strong––with growth of real GDP in the vicinity of 3.5 percent. There are relatively few indicators for the first part of this year, but those that are available are consistent with this scenario. Tourism, for instance, is holding up relatively well. Air arrivals increased 5.2 percent year-on-year in the first half of 2001, while cruise arrivals increased 4.1 percent over this period.

While still low, inflation rose slightly in 2000, as higher international fuel prices fed into domestic costs. With fuel prices expected to be fairly stable in 2001, inflation is likely to fall. In the year to May, consumer prices rose 1.5 percent.

Policies

While the Bahamian authorities have always taken their responsibilities with respect to the financial sector seriously, perhaps more seriously than the international community has appreciated, they accelerated and intensified their efforts to strengthen supervision of the offshore financial sector and to counter money laundering under the intense international pressure that has been exerted recently. The substantial efforts made are well-covered in the staff report in paragraphs 12 and 28 and Appendix V, so I will only highlight a few key points:

The comprehensive package of legislation that was enacted on December 29, 2000 includes the requirement to cooperate with foreign regulators and the legal powers needed to do so. It also addressed areas where confidentiality had been too strict—the IBC Act was repealed and bearer securities were eliminated

The rules for domestic and offshore banks are basically the same; the only difference is that the domestic banks must report more frequently on liquidity because they have access to the lender of last resort.

The money laundering legislation has strong know-your-client rules, and compulsory reporting at an appropriate threshold with a suitably broad coverage of transactions, including accountants, lawyers, real estate agents, casinos, and charities. It also established a FIU that reports directly to the Attorney General.

Not only has new legislation been enacted, it is being used. For example, a court order in May required an offshore bank to reveal the identity of the owner of a bank account that the Canadian authorities suspected was being used for insider trading in stock transactions. The Bahamas has also cooperated with authorities from Brazil, the Philippines, Switzerland, and the United Kingdom on various matters. And to date, the licenses of 48 banks and trust companies have been revoked.

In recognition of The Bahamas commitment and willingness to combat money laundering, in late June, the FATF removed The Bahamas from its list of "non-co-operative" jurisdictions.

I would like to add that, although these efforts seriously taxed the limited administrative capacity of the authorities, they did not neglect their other responsibilities for the financial sector. In particular, they continued to receive, carefully review, and follow up as necessary the monthly reports submitted by banks.

Turning to fiscal policy, the preliminary estimates for the 2000/01 financial year are that the central government deficit decreased to 0.2 percent of GDP and central government savings increased to 2.4 percent of GDP.

The Policy Challenges and Objectives Ahead

The authorities agree with the staff that their main challenge is to build on the commendable policy efforts that have been made to sustain a favorable environment for investment and growth and further reduce unemployment. They also agree with the emphasis on maintaining a prudent fiscal stance, and enhancing competitiveness and implementing pending structural reforms.

Prudent Fiscal Policy

The authorities are in agreement with the staff's advice to further strengthen the current surplus to make it possible to increase government investment. With this in mind, they intend to take measures to enhance revenue, while continuing their cautious approach to spending, especially wage expenditures. Even with an election in the offing, the government has resisted the temptation to ease; the budget introduced on May 30 for the financial year that began on July 1 calls for an overall position of balance. As well, the government will soon introduce legislation aimed at strengthening fiscal responsibility and ensuring fiscal sustainability.

On taxation, the government has launched an effort, which is expected to take 4 years to complete, to improve the collection of property taxes by reassessing property values and improving administrative procedures. They have also continued to address the high level of some tariff rates and the broad dispersion of tariffs. In the 2001/02 budget, for example, there are steep reductions—from 210 to 35 percent—in the tariff on some foodstuffs, where extremely high duties were previously used to protect high-cost local producers. This move will benefit consumers as well as the hotel sector. Nevertheless, there are still 29 tariff rates, ranging from 5 to 210 percent, with an average import duty rate of 25-30 percent. The Bahamian authorities intend, with the assistance of FAD, to conduct a comprehensive assessment of the tax system with the aim of establishing a better system of indirect taxation.

Credit Policy

The rapid growth of credit in 2000 noted by the staff was attributable to an important extent to growth in mortgage lending. The strength in housing activity in 2000 was somewhat of an aberration in that housing starts had been squeezed in earlier periods as construction capacity was allocated to the hotel sector, so there was an element of catch up. Recent data suggest that growth in mortgages is tapering off. As well, private lenders are reporting minimal losses on their mortgage portfolio. Nonetheless, on July 20 the central bank took the prudent step of issuing an advisory to banks in regard to exercising restraint in credit expansion. The authorities will continue to monitor credit growth closely and are prepared to take the measures proposed by the staff—imposing stricter equity requirements for consumer loans and/or temporarily raising legal reserve requirements—should it appear necessary.

Regarding the development of indirect instruments for the implementation of money policy, the authorities are discussing technical assistance with the World Bank for establishing auctions of government bonds.

Financial Sector

The authorities intend to continue their efforts to strengthen financial sector supervision and stability. In the second half of this year, they intend to move into more intensive risked-based on-site inspections of financial institutions, including an examination of their loan classification policies.

Following a self-assessment during the remainder of this year, they will request a Fund-led assessment focusing on the offshore financial sector in the first quarter of 2002. This will be followed by an FSAP in the context of the 2003 Article IV consultation.

Infrastructure/Privatization

An audit of BATELCO's accounts to December 2000 has been completed. The company will soon be transformed from a statutory corporation into a private company, with parliamentary approval required for the subsequent sale of shares. This is expected by year-end. The electricity utility is slated to be privatized next year.

The authorities are also considering the possibility of either privatizing Bahamasair, or permitting other private carriers on domestic routes.

Labor legislation

The legislation that is planned for enactment later this year seeks to ensure minimum working conditions for all Bahamian workers in line with ILO standards. The authorities appreciate the concerns of the staff that the minimum wage provisions and the shortening of the work week in some sectors may adversely impact competitiveness. They think, however, that the level of the minimum wage that is contemplated takes adequate account of prevailing relative wages and certain jobs with a significant "tipping" component in their remuneration, such as gas station attendants, retail packers, and domestic workers, would be exempted from its application. As well, most of the economy already has a 40-hour work week, and the reform would be introduced gradually for the two sectors expected to be the most affected—the construction and retail industries. In addition, the authorities anticipate some changes in productivity as a result of the minimum wage and changes to the work week to help contain the impact on labor costs and competitiveness.

Extending his remarks, Mr. Bernes said that the authorities had now applied for accession to the WTO which was another sign of their commitment to participate openly and actively in the international economic system. The wish to accede to the WTO meant undertaking both joint and separate negotiations with the United States, with the European Union, with Japan, with Canada, with Mexico and others. It was a long and complicated process, and it was a testament for a small country that they had undertaken to go that route, and it showed their commitment.

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

We thank staff for a well-written report and Mr. Bernes for his helpful statement.

We commend the authorities for the implementation of sound macroeconomic policies that has allowed the Bahamas to achieve a sustained improvement in per capita income. In 2000, the economy registered its ninth consecutive year of positive growth, unemployment fell to its lowest rate and inflation remained low. The public finances continued to improve, reaching near balance. Moreover, net capital inflows, based on foreign direct investment and other private inflows, were sufficient to finance the large though declining current account deficit, and to accumulate reserves. We encourage the authorities to consolidate these gains over the medium term, broadly supporting their strategy based on fiscal prudence, increased competitiveness in tourism and financial services, and structural reforms, particularly to bring the financial sector in line with international best practices and standards.

We welcome the authorities' commitment to achieving a balanced budget this fiscal year, but if they are to meet their medium-term objective of strengthening the central government's savings rate to at least 3 percent of GDP, they will need to enhance revenue administration and address potential expenditure pressures. Staff has recommended a range of possible options in this regard. We are encouraged, in particular, by the authorities' receptiveness to implementing a sales tax or VAT that would allow for a significant reduction in import tariffs. Developing a more streamlined and transparent regime with respect to tax exemptions and concessions would also go a long way in strengthening the fiscal position. On the expenditure side, we stress the importance of maintaining a prudent wage policy, since the wage bill accounts for more than half of current expenditures, and proceeding with plans to lower subsidies to selected public enterprises. The introduction of fiscal responsibility guidelines planned for later this year would help maintain discipline over the medium term.

We note that monetary policy is correctly focused on maintaining the credibility of the pegged exchange rate arrangement and achieving price stability. However, the direct instruments used by the Central Bank of the Bahamas to influence excessive credit growth, namely, moral suasion and personal equity (down payment) requirements for consumer credit are not appropriate. Besides, they are unlikely to sufficiently contain pressures on the international reserve position following liberalization of capital controls. We, therefore, encourage the authorities to work toward employing a broader mix of indirect instruments to enhance the efficiency of financial intermediation and monetary control, including a greater reliance on open market operations and allowing a greater role for interest rate policy. In the interim, the central bank should stand ready to tighten conditions through higher reserve requirements or stricter equity requirements should excess credit growth begin to threaten macroeconomic stability.

Regarding the medium-term outlook, we note a further narrowing in the current account deficit, comfortably financed by private capital flows and allowing for reserve accumulation. However, for a small services-oriented economy like the Bahamas that is contemplating capital account liberalization and faced with the downturn in the U.S. economy, we wonder whether the actual and projected reserves are adequate. Could staff, perhaps, comment on what should be the benchmark for an adequate international reserve coverage?

We welcome the authorities' decision to move ahead with the privatization of the telephone and electricity companies and the liberalization of the telecommunications sector, and look forward to similar efforts with respect to other public services. Regarding the introduction of the minimum wage, we concur with staff on the need for a uniform wage rate that seeks to raise the limited supply of labor, and on the need to evaluate the impact of the minimum wage and a shortening of the work week on labor costs.

We welcome the timely and decisive efforts of the government to establish a package of financial services legislation dealing with offshore supervision and money laundering, in response primarily to the international initiative by FATF. Measures include a strengthening of enforcement capacity, audits by foreign supervisory authorities and several on-site inspections. As a result, the Bahamas was removed this June from the FATF's list of non-cooperative territories in the fight against money laundering. We also welcome the authorities intention to carry out a self-assessment exercise later this year, and to follow up with subsequent assessments, including an FSAP.

Given the importance of timely and reliable data to macroeconomic planning and to making appropriate policy decisions, we encourage the authorities to improve the coverage and quality of the Bahamian statistical base, particularly with regard to data on private sector debt and the national accounts. In this regard, we look forward to the early establishment of CARTAC, the Caribbean Regional Technical Assistance Center, which will improve the range and quality of technical assistance available to Caribbean countries.

In conclusion, we wish the authorities every success in their endeavors ahead.

Mr. Abbott made the following statement:

The Bahamian economy has performed very strongly since the mid-1990s. The external environment created a growth opportunity and The Bahamas seized it. The authorities are to be commended for their skillful management of economic policy. The fiscal accounts are in good order and National Insurance Board programs are soundly funded. External reserves appear to be a little light, but monetary policy is well disciplined within the confines of a very well established peg to the U.S. dollar.

We can endorse the staff report and I have only a few observations to make.

We are pleased to see that tax reform is coming onto the policy agenda. Import duties are excessively complicated and distortionary so a switch to a sales tax or a value-added tax, as is being considered, would provide a more economically efficient source of revenue. Likewise, the planned update of the property tax regime will be important for both equity and revenue reasons.

The staff recommends that the overall tax effort be boosted to increase government saving and expand the scope for public infrastructure investment. A small boost in revenue to support more investment is probably justifiable, although we are not overly enthusiastic about encouraging a higher level of taxation since the Bahamas already has a well-developed public sector with a moderate level of taxation. In evaluating this recommendation, it would be helpful if staff could elaborate a little on the priorities they have in mind for additional public investment. Will restructuring or privatizing loss-making public enterprises free up resources that could be redeployed to infrastructure investment?

We emphasize "loss-making" because one of the attractive features of the Bahamian public sector is that the important electricity and telephone companies run operating surpluses. Work seems to be in train to improve the management of Bahamasair and the Water and Sewage Company so we hope this will lead to reduced transfers from the central government even before privatization.

The investment currency market sounds like a relic of days gone by so we are pleased that the authorities are giving consideration to relaxing restrictions on outward investment. In implementing this liberalization, we would encourage the authorities to follow the staff suggestions regarding parallel moves to introduce indirect monetary instruments and to align the interest rate structure with rates abroad. In any case, we would expect that a reduction in the investment premium would, itself, tend to narrow the spread between domestic funding and lending rates.

My authorities are very pleased by the significant improvements that have been made over the last year in The Bahamas' anti-money laundering regime and in its supervision of offshore financial activities. The scope of this progress was confirmed at the meeting of FATF a few weeks ago when The Bahamas was removed from the NCCT list. The regime is still new and implementation will still need to monitored. We will be particularly interested in following the issuance of secondary legislation and regulatory guidance, the diligence with which the new regulations are enforced, and the practical cooperation extended to other international counter parties.

Mr. di Maio made the following statement:

As Mr. Bernes said, it is difficult not to praise the remarkable economic performance in The Bahamas in recent years. Obviously, the commitment to a sound macro management over the period has increased investment and growth. The key seems to have been to restore confidence in the government's economic management and created the environment for private sector growth. On the policy front, The Bahamas provides a valuable lesson to other small island states, a number of which are in our constituency. The increases in investment have not been due to government guarantees or other large government funded infrastructure programs and it is a welcome development. The potential of The Bahamas—the people, the location, its resources—is huge. In terms of the best way forward, and the best way to realize this potential, we largely agree with the authorities' policy program as outlined in the staff report.

On fiscal policy, we generally support the intention to look at strengthening the guidelines for fiscal responsibility with the focus on the medium term, and in that regard, we support the suggestion that the framework ensures public investment is not treated as a residual in order to meet other fiscal targets. In the short term, we support the recommendations to increase the amount available for further public investment through removing tax exemptions and reassessing property values. This makes sense in its own right to improve efficiency and equity, and has the welcome side effect of providing more revenue. However, there is little information in the report on the nature and extent of exemptions. I wonder if staff could tell us whether these are ad hoc or directed to encourage investment in particular sectors, for example tourism.

As Directors have previously noted and we generally agree, there is a need for a comprehensive reassessment of the tax system with regard to addressing the overall reliance on import taxes. We welcome the intention to seek the Fund's assistance with these improvements.

An important adjunct to improving fiscal responsibility will be to increase the accountability and transparency of the government-owned enterprises, although the balance overall on these entities does not seem to create a large fiscal risk at the moment, there seems to be important individual performances within the overall figures. As the better performing enterprises are privatized this will become more obvious. In addition, there is also the issue of them competing with the government's other priorities for investment, so that either they suffer from under investment or alternatively crowd out investment in social and physical infrastructure.

On the issue of the privatization of the telephone company, I understand this was initially slated for privatization at the end of 1998. I wonder if staff could comment for the prospects of privatization in the near future. Nevertheless, there are some good reasons to proceed with caution given that potential telecom investors are unlikely to have a great deal of spare cash at the moment. Experiences with privatization suggest the need for careful consideration of policy frameworks and ownership structure and this seems to have been the case in The Bahamas. However, one of the most difficult things to get right is the selection of an investor with experience, commitment, and the money to ensure further investment in the company is profitable. With these comments we realize why perhaps progress has been slower than expected. I wonder if the staff could elaborate on the authorities' intentions with regard to the proceeds from privatization, and whether they have a particular target in mind for reserves.

With regard to indirect monetary policy instruments, we are of the view that the high fixed costs may prove a barrier to the staff's recommendation. Moreover, there is a need to carefully look at the transition mechanisms through which interest rates affect credit demand. This sounds simple, but in small island economies, these are likely to be quite different than developed economies. We suggest that this policy recommendation is given further careful thought and analysis.

The move to allow greater freedom of capital movements is welcome and should be accompanied by strengthening of supervision in the banking sector, and the international reserves position. Although The Bahamas has a credible fixed exchange rate regime, does staff consider that the level of international reserves pose a risk if there were to be a significant shock to the economy. In this regard, we wonder whether there is a lender of last resort facility and timely and effective processes for intervening in problem banks.

On the issue of labor legislation, there does not seem to be an obvious incompatibility with the aim to ensure minimum working standards in line with the ILO and the need to respect flexibility in part-time and temporary employment. The authorities have designed the legislation flexibly to take account of the labor market structure and to limit the adverse effect on competitiveness. As Mr. Bernes notes, most of the economy is already operating on a 40 hour week and where this is not the case, the measures will be introduced gradually. We would, however, suggest that the authorities look carefully at providing an alternative minimum wage for the young and unskilled.

Lastly, we commend the authorities for the comprehensive and timely response for strengthening the supervision of the offshore financial center and enhanced measures to combat money laundering. We understand that these measures are likely to have minimal effect on overall economic activity in the sector as some virtual institutions are translated into real ones. We hope the new framework provides the basis for the offshore center to contribute to the economic growth in The Bahamas. With these comments, we wish the authorities continued success.

Ms. Wei made the following statement:

I would like to thank the staff for the concise paper and Mr. Bernes for his very informative statement. Again, we are very impressed by what the economy has achieved in the past two years, not only in terms of economic growth but also with regard to improvements in supervising the off-shore financial sector and countering money laundering. We congratulate the authorities for having done a remarkable job in pursuing prudent economic policies, creating a favorable business environment, and proceeding with tariff reduction, tax reform, financial supervision, and structural reforms.

We are in broad agreement with the staff appraisal and would like to address the following points.

Prudent fiscal policy will continue to play a central role in the authorities' macroeconomic management. Mr. Bernes's statement indicates that the authorities are committed to a balanced budget which will be supported by revenue-enhancing and spending-containing measures. To increase revenue, the authorities are considering the option of indirect taxation in addition to improving tax collection. To control spending, the authorities will introduce legislation aimed at improving fiscal responsibility and ensuring fiscal sustainability. The huge reduction in tariffs is a welcome move and yet the economy would benefit more from lower tariff rates. Further tariff reduction is encouraged.

We would like to join other speakers in commending the authorities for their swift and resolute actions in introducing and enforcing legislation in offshore financial sector supervision, money laundering and tax practices. Mr. Barnes's statement reveals the concrete progress made so far. We would urge the authorities to take advantage of the Fund's technical assistance in building the administrative capacity in offshore financial supervision and anti-money laundering.

One central task of the authorities is to lower the unemployment rate which has already improved substantially in the 1990s. We recognize the authorities' efforts in increasing spending in education and training to improve labor productivity and labor skills. On the new labor legislation which brings working conditions for workers up to the standards of ILO, we think this is laudable progress and tend to agree with the authorities that the minimum wage provisions and shortening of the work week may improve productivity and thus contain the impact on labor costs and competitiveness. On the other hand, more job opportunities may be created through shortening the work week.

To conclude, we encourage the authorities to continue their sound economic policies, strengthen their efforts on financial sector supervision and continue to improve the social services. We wish the authorities every success in the future.

Mr. Walsh made the following statement:

It makes a pleasant change for me to have an opportunity to discuss The Bahamas. Having spent much of the last year encouraging small island economies with significant offshore banking sectors to work closely with the

FATF and the Fund on anti-money laundering and financial sector surveillance, it is encouraging to find a member who has readily embraced the challenge. I commend the Bahamian authorities for recent policy efforts. Mr. Bernes's statement rightly notes the significant strides taken by the authorities on anti-money laundering measures. Those strides have been recognized by the international community, and FATF has now delisted The Bahamas. Going forward, continued strong implementation of the tougher measures will ensure that The Bahamas continues to be seen as a valued member of the international financial community. I trust that the progress on these policy issues will be suitably reflected in today's summing up.

The staff representative from the Western Hemisphere Department (Mr. Di Tata) made the following statement:

Staff share the concern about the international reserves and believe that the medium-term level should be regarded as a minimum level of reserves. We have an increase in reserves from a level of at present 95 percent of base money to over 110 percent of base money by 2005, and coverage of imports moving from one and a half to two months. In arriving at this number we had to balance several factors. The Bahamas is contemplating a liberalization of the capital account, and there is a large private sector credit component, equivalent to about 70 percent of GDP, as well as a high multiplier. These factors argue in favor of having a high level of reserves.

At the same time, however, there are other considerations that are worth mentioning. For instance, if there were to be a prolonged downturn in the United States, and a decline in travel receipts in The Bahamas, the high import component would automatically be reduced. Also, the current coverage of imports could underestimate the relevant coverage, because there are some imports that are automatically reexported. Once we correct for that, we have a number that is closer to two months' of imports. In addition, The Bahamas has easy access to international markets at relatively favorable interest rates, the capital account liberalization would be gradual, and the ratio of international reserves to short-term public external debt is in the order of 600 percent. At the same time, in the staff projections we have not included any accumulation of reserves due to privatization, meaning that that would come on top of the projected level of reserves for the medium-term. Also, the variability of reserves has not been large in recent years. The minimum levels of reserves in 1995 and 1996 were at about 70 percent of base money.

Regarding indirect monetary instruments, staff believe that the authorities should look at this issue, as currently the main instruments of monetary control are moral suasion and the use of down payment requirements on consumer credit. We believe that there is a need to allow interest rates to play a greater role in containing credit growth, particularly in the context of capital account liberalization. In addition, The Bahamas' financial system, for an island economy, is more sophisticated than in other islands. There are 16 banking institutions, and the degree of monetization is high at 70 percent of GDP. The authorities already have an auction for treasury bills, and they want to go ahead with introducing an option for government bonds. It is therefore a matter of perfecting instruments that are already in place. In any event, the staff and the authorities agree that in the meantime there will be a need to continue relying on traditional instruments.

With regard to the privatization of the telephone company, one obstacle to the privatization was the audit of the company's accounts Now that the audit has been completed, the company is expected to be transformed from a statutory corporation into an incorporated company, but there is a need for parliamentary approval for the subsequent sales of shares to the private sector. The government has a large majority in parliament, and is committed to proceeding with the privatization before the end of this year.

With regard to the proceeds from the privatization, the authorities have indicated that they intend to use a large part for the repayment of debt, which at 40 percent of GDP is still relatively high. The remainder will be used to further strengthen the net international reserve position, but the authorities do not have a specific target.

Regarding the lender of last resort facility, in September 1999 parliament passed the Protection of Depositors' Act, which provides for an insurance scheme for deposits up to a maximum of 50,000 Bahamian dollars. There was an initial contribution from the central bank and domestic banks, alongside a government guaranteed issued bond to provide resources for this fund. Now, under the terms of the act, the banks contribute with a premium equivalent to 0.05 percent of deposits. In addition, the Central Bank can provide loans to commercial banks for an amount not exceeding 85 percent of the market value of the banks' collateral.

Exemptions and concessions in The Bahamas are widespread. There are investment incentives exempting from customs duties on materials, equipment, and property taxes for up to 20 years. This benefit applies to hotel operators, exporters of manufactures, agricultural businesses, and spirit and beer producers. An estimate of the impact of these concessions and exemptions for the last fiscal year, including those applicable to companies in the Freeport free-trade zone, shows that they were in excess of 3 percent of GDP. Also, there are some traditional exemptions for diplomatic purposes, and for certain agricultural products and industrial items.

On the strengthening of public savings, the government needs to increase public investment, particularly to improve roads and the hospital infrastructure. I agree that something could be done in terms of reducing transfers to some public corporations, and this year the budget incorporates a significant reduction in these transfers. But this is a political issue and the scope for further reductions on some of these transfers is limited. Some of these companies have structural problems, like the water and sewage company, and it will take time until these problems are resolved. The solution will have to be a mix of increasing revenue and better management of these companies.

Mr. Bernes made the following concluding remarks:

Let me thank chairs for their comments. As I tried to indicate in my statement, it has been a remarkable decade. This government, which took office at the beginning of the 1990s, under difficult circumstances, has consistently applied a policy which has turned the economy around and laid the foundations for stronger performance in the future. Both the prime minister and the minister of finance have indicated that they will be stepping down before the next elections, and that these discussions would be their last as a government. I note that the record of achievement is impressive, and that they leave behind a strong foundation for their successors.

The authorities recognize that there is a need to move to a more buoyant tax system over time, but this is a challenge on which the new government should take the final decisions. However, through technical assistance and other means, they are laying the foundation to carry out the proper analysis. On the question of exemptions, this is a problem in the region as a whole, and is therefore an issue that has to be tackled on a regional basis.

Indirect instruments for implementing monetary policy is a topic where it would be useful for staff to take a look, as the same issue arose in the Article IV discussion with Barbados. In small island countries where the amount of competition in the banking system can be a question, that is an issue. There is a debate as to how effective indirect instruments can be and whether authorities should rely on them or whether there is a need to have other instruments. Therefore, it would be useful for staff to take a broader look at this issue on a more general basis, and to come back to the Board.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their continued adherence to sound macroeconomic policies, which had contributed to a sustained economic recovery led by substantial inflows of private investment, a decline in unemployment, and an improvement in the country's social indicators. Directors noted that the main challenge for the period ahead was to build on these accomplishments by maintaining a prudent fiscal stance, enhancing competitiveness, and pressing ahead with pending structural reforms.

Directors welcomed the progress made by the authorities in almost eliminating the central government deficit, as well as their commitment to achieve a balanced budget position this fiscal year. They felt, however, that additional efforts were needed to further strengthen central government savings to ensure an adequate level of public investment to sustain growth. In this connection, Directors noted that revenue could be strengthened by reducing tax exemptions and improving property taxation, and that the import tariff system needed to be rationalized by lowering high tariff rates and tariff dispersion. The authorities' decision to conduct a broad review of the tax system with Fund assistance, with a view to evaluating the possibility of introducing a sales or value-added tax, was welcomed. Directors supported the authorities' request for technical assistance in this area.

Directors stressed the need for adherence to a prudent wage policy to maintain fiscal discipline and avoid parallel wage pressures in the private sector that could affect competitiveness. They encouraged the authorities to proceed with current plans to lower government transfers to certain public corporations by reducing their operating costs, and to improve the reporting practices of these corporations. The planned introduction of fiscal guidelines was considered a positive step for preserving fiscal discipline over the medium term.

Directors cautioned the authorities to monitor credit developments closely and tighten the credit stance as necessary to protect the international reserve position. They also encouraged them to work on the development of indirect monetary instruments and to allow interest rates to play a greater role in containing credit growth.

Directors commended the authorities for their major legislative effort made within a short period of time to address international concerns about offshore supervision, money laundering, and tax practices, as well as for the decisive steps taken to implement the new legislation. Looking ahead, they underlined the importance of broadening the scope of on-site inspections of financial institutions and of monitoring closely the quality of the banks' portfolios. The authorities' intention to conduct a Fund-led assessment focusing on the offshore sector following a self-assessment to be completed during the remainder of 2001 was welcomed, as well as their willingness to complement such an exercise with a comprehensive evaluation of the financial system under an FSAP.

Directors were of the view that the long-standing fixed exchange rate regime had served The Bahamas well. They observed that sustaining a strong performance in tourism and other key sectors depended crucially on containing labor costs and raising labor productivity through continued emphasis on education and training. The prompt privatization of the telephone and electricity companies and the opening of the telecommunications sector to competition were considered important to modernize infrastructure and improve the delivery of these services.

Directors emphasized the need to analyze carefully the implications of the draft labor legislation that has been submitted to parliament so as to avoid a significant increase in labor costs that could have an adverse impact on external competitiveness. They highlighted the need to preserve flexibility with regard to part-time and temporary employment, and reduce rigidities in labor arrangements. Directors also welcomed The Bahamas' interest in acceding to the WTO.

Directors encouraged the authorities to address quickly several statistical weaknesses that hamper the assessment of economic developments, including by developing data on private sector debt and the national accounts for the period beyond 1995.

It is expected that the next Article IV consultation with The Bahamas will be held on the 24-month cycle.

3. IRELAND—2001 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 2001 Article IV consultation with Ireland (SM/01/218, 7/11/01; and Cor. 1, 7/26/01). They also had before them a report on Ireland's observance of standards and codes (ROSC) on financial policies (SM/01/63, 2/21/01, Cor. 1, 2/23/01).

Mr. Charleton submitted the following statement:

I would first like to express my authorities' appreciation for the work of the staff. When a country has been performing so well it would be easy to become complacent or to think that reform of the economy has been completed. This report is very helpful in focusing on the issues which have to be addressed to secure our continued economic success.

A year ago we were discussing an economy where growth was accelerating from an already unsustainably high level and which was exhibiting many of the classic signs of overheating, with a growing danger of a sharp, unpleasant correction. Directors were concerned about rising inflation, the stance of fiscal policy, wage growth and asset prices, especially the housing market. The economy was accelerating in the face of ever tighter capacity constraints. In the event, GDP grew by a remarkable 11.5 percent in 2000 and GNP by 10.4 percent, after several years of about 8 percent.

The tone of this year's report is, however, much more sanguine and the risks seem to have diminishing considerably. The economy seems likely to grow by about 7 percent in 2001. While this is still remarkably strong and still in excess of the sustainable long-run trend, it nonetheless represents a considerable slowdown and it is difficult to judge the trajectory over the coming months. As in other European economies, the initial slowdown appears to have been domestically driven, partly by exceptional factors such as the foot-and-mouth scare. Ireland is, however, and will always remain a very small, very open economy and its growth prospects depend on a vibrant world economy. The current slowdown is being fundamentally driven by global developments, especially in the high tech sectors which were the major engine of growth in the 1990s. My authorities share the concern of many others about growth prospects in the major industrial countries, especially in Europe.

It is clear from the report that Ireland remains highly competitive, with flexible labor and goods markets and an extremely strong fiscal position. If the world economy performs reasonably well, the prospects for Ireland remain very positive. The constraints in growth are still likely to emanate from the supply-side of the economy and the focus on policy is still on enhancing potential output.

The debate on the significance of relatively high inflation in some of the euro-area countries is ongoing. Towards the end of 2000, inflation accelerated quite sharply in Ireland, with the year-on-year rate reaching 6 percent (on an EU harmonized basis) and a wide differential opening vis-à-vis the euro-area countries. While the underlying rate was not as bad, the high headline rate threatened the national wage agreement and to undermine social consensus. There was a danger of a wage/price spiral. Since then, however, inflation has eased somewhat to 4.3 percent, whereas it has risen in Europe and the differential over the EU average is only 1.3 percentage points. Ireland now has the fourth highest inflation rate in the euro-area and staff consider present differentials as consistent with Balassa Samuelson- type effects. Domestic inflationary impulses cannot be discounted but the weakness of the euro tends to have a disproportionately large impact on Irish inflation. The cumulative rise of 1.5 percentage points in European interest rates was welcome from the Irish perspective both for its direct effect and for its psychological impact in a country where people had become accustomed to interest rates continuously falling. We have witnessed a significant fall-off in credit growth.

The appropriateness of the stance of fiscal policy in Ireland depends on your view of potential output. Many commentators have considered fiscal policy to be expansionary in the face of already rapid growth. At the same time, we have witnessed sharp declines in the ratio of both revenue and expenditure to GDP, very large surpluses and a dramatic reduction in the debt/GDP ratio to one of the lowest in Europe. The staff view seems to be that, in retrospect, there has not been a lot wrong with Irish fiscal policy in recent years. They feel that it was somewhat pro-cyclical in 2001 but acknowledge that the stimulus was not large and do not see a mid-year correction as warranted. Moreover, over the medium term they see no need for a bias toward structural tightening or loosening. The advice for a broadly neutral stance in terms of cyclically adjusted balance seems sound.

My authorities do not dismiss the demand effects of fiscal policy in an economy as open as Ireland but much of the focus of fiscal policy has been on the supply side of the economy. While many of the tax reductions were in the context of the multi-annual wage agreements, they were necessary to stop the overall tax burden rising and their essential thrust was a comprehensive reform of the tax structure to enhance work incentives. The other major driving force of fiscal policy has been very active public capital program to ease the many infrastructural constraints on the economy.

Looking forward, it now appears that for the first time in many years, fiscal revenue will fall short of budget projections. Given that a surplus in excess of 4 percent of GDP was budgeted, a somewhat smaller than projected budget surplus would not be disastrous but my authorities concur with the staff on the need to contain the growth of public expenditure and on the challenge facing budgetary policy in 2002, when rising public expectations in terms of both pay and services may well clash with a slowing growth trend.

On overall pay developments and on public sector pay in particular, my authorities find the staff too sanguine. It may indeed be true that if wages were to rise by about 10 percent this year as seems likely, it would to a large extent represent catching up on past productivity and would not undermine competitiveness. It is a very large proviso, however, that this be a temporary phenomenon. Unfortunately, wage expectations tend to be extrapolative and, even with a weaker economy, wage pressures may well persist at a high level in 2002. Irish competitiveness has also been underpinned by the weakness of the euro. A consistent strengthening of the euro allied to wage growth well in excess of that both inside and outside the euro area could quite rapidly undermine competitiveness. Quite large sectors of the economy remain vulnerable to wage and price developments vis-à-vis the U.K. The report acknowledges the difficulty in controlling public sector wages in the face of persistently large surpluses and tight labor market conditions. The benchmarking exercise represents an innovative attempt to sort out the complex issues of wage relativities both within the public sector and between the public and private sectors.

My authorities do not share the staff view that the broad national wage agreements that have characterized the wage process over the past 15 years have outlived their usefulness or that they should not apply to the private sector. These series of broad agreements on wages, taxes, social benefits, etc. have made a very positive contribution to the general economic environment which has helped to underpin the remarkable economic growth. They have not been rigid, nor frozen differentials and a labor market which has nearly doubled the number of people at work is clearly functioning well. There is general agreement that these type of multi-annual deals need to adapt to changing circumstances but the fundamental approach of broad consensus on policy among all social partners remains attractive. If the costs of a new agreement for any of the partners involved seemed too high then they will not reach agreement on a further three-year deal.

Throughout the period of economic growth, credit has grown rapidly and private sector indebtedness has risen to record levels. The housing market, in particular, has exhibited classic signs of overheating. At the same time, financial market liberalization, competitive markets and the advent of the single monetary policy have left the authorities with very few instruments to moderate asset market behavior. The authorities have, at all times, been conscious that historically an over-extended property market can be a catalyst for a major economic correction. Financial sector supervision in Ireland has been continuously intensified and this issue was one of the major factors prompting Ireland to be among the first volunteers for an FSAP.

Even though the supervisory regime is strong and the FSAP found a robust banking system, my authorities have continued to focus on improving whatever aspects they can and have been refining 'stress testing' of banks.

Over the past six months or so, housing prices seem to have broadly stabilized. This is a welcome development which diminishes the risk of a severe market correction which would have been inherent in a continuation of the preceding fall in house price rises.

The staff put a certain degree of emphasis on deregulation and privatization. Whilst not disagreeing, my authorities would stress that most markets in Ireland are already largely deregulated and the retail sector is highly competitive. Telecommunications have been privatized and the electricity industry (the other major utility) is being opened to competition. In reality, privatization in Ireland has been pragmatic rather than ideological. There is a well-established tradition of state-owned enterprises operating on a full commercial basis. In those areas where there is still scope for liberalization, such as the alcohol trade, pharmacies, below-cost selling of certain food items and transportation, non-economic factors relating to the provision of services across a small thinly dispersed population play a role. My authorities will continue to pursue deregulation but do not consider that over-regulation or lack of competition are serious constraints on economic growth.

Paragraph 38 of the staff report alludes to the rejection in a referendum of the Nice Treaty. While this Treaty concerned the accession of Eastern European countries to the EU, it was a complex Treaty covering many issues.

Its rejection in Ireland appears to have been due to issues of European security and defense and to a sense that Brussels is out of touch with the citizenry. I can assure colleagues that there remains strong support in Ireland for EU enlargement.

Paragraph 40 notes a small rise in the percentage of GNP devoted to ODA. This, however, partly reflects the very rapid growth of GNP. The actual increase in 2000 was 27 percent and my authorities are firmly committed to achieving the 0.7 percent of GNP target by 2007.

Overall, the Irish economy has performed remarkably well for a prolonged period without any major imbalances arising. It is well positioned to continue to prosper but it is very small and very open and ultimately its prosperity depends on vigorous growth among the major industrial countries.

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

The Irish economy continued to be a star performer in the European Union and the world. Sound economic policies, substantial capital inflows, and large investments in infrastructure and education helped achieve a remarkable transformation of the economy, leading to high levels of growth reaching nearly 12 percent and employment generation, reducing unemployment to a low of about 4 percent in 2000. The economic outlook appears favorable, with growth slowing to still substantially high levels and the fiscal balance remaining in considerable surplus. As Mr. Charleton points out in his insightful preliminary statement, global developments are likely to play a major role in determining Ireland's performance in the period ahead. However, the country's ability to adapt to external shocks and maximize growth given a certain external environment will depend on continued pursuit of sound macro and structural policies.

Ireland's main challenge is to adapt policies to take account of two main considerations related to the new environment the country is facing. These are the transition to a sustainable and steady level of economic activity given the current high and possibly unsustainable rate of growth and full employment, and the less than friendly global economic conditions. The sharp slowdown in the global economy is likely to dampen economic activity, particularly in the high-tech area where a significant part of Ireland's dynamism originates.

The focus of policy should be centered on the fiscal area. Fiscal consolidation has already come a long way. The authorities' accomplishments on this front include, in addition to a considerable surplus, an improved tax structure and the accumulation of substantial resources in a pensions reserve fund. These achievements, along with the sustained high growth rate of the economy, have led to a reduced public debt burden and a solid medium-term fiscal outlook. Despite this impressive performance, there remains a need for further reforms in certain areas. For example, there is still a considerable room for further improvements in the tax structure in the form of rate reductions and broadening of rate bands as well as broadening the VAT base and standardizing its rates in order to minimize distortions.

On the expenditure side, it would be important to contain the wage bill and rationalize transfers, which constitute a large part of current spending. Furthermore, a priority should be given to reforming the national wage agreements framework. In this regard, we would underscore the dangers identified by the staff in setting public sector wages through trading of tax cuts and spending increases to reach a certain wage package. This process is likely to undermine the role of the budget in overall policy determination. This would be a matter of serious concern due to the importance of fiscal policy in the absence of a national monetary and exchange rate policy. The need for reforming the wage determination framework is further underscored by considerations of competitiveness particularly if the overvaluation of the dollar against the euro is reversed in the near future.

As regards capital spending, we understand the authorities' emphasis on the need to continue to address bottlenecks in the infrastructure in order to enhance output potential. However, it is important to prioritize major projects in view of the severe shortages in factor markets, particularly in construction. Furthermore, the private sector should be encouraged to play a larger role in the provision of infrastructure and utilities, including in the transportation and electricity sectors.

Turning to the appropriateness of the fiscal stance, notwithstanding the difficulty in estimating potential output, which complicates a discussion of this issue, we tend to agree with the staff that this stance should have been neutral for 2001. This position is motivated by our preference for a cautious approach in this area especially when the economy is growing at a remarkable rate. We would, therefore, endorse the recommendation to save any underspent budgetary allocations and to stand ready to reduce discretionary expenditure as needed to ensure achievement of the 2001 overall surplus target. Beyond 2001, we would encourage the authorities to put in place a medium-term fiscal framework which would be useful in guiding expectations and preempting emerging spending pressures. We also share the staff's view that it would be prudent to shift to a neutral fiscal stance in the 2002 budget. However, we should be careful not to dismiss the possibility that developments may in fact warrant a tightening of this stance in the not too distant future, especially in view of the concerns we raise above about the likely increased burden on fiscal policy as the ability of the economy to expand at the current impressive rate diminishes.

An important risk that may arise in a fast growing economy like Ireland's is that a sharp decline in growth may lead to a significant negative impact on the financial sector. This can be exacerbated by a decline in real estate or financial assets. While these risks have not totally diminished, they have declined somewhat with the recent moderation in the growth rates of the economy, asset prices, and private credit towards more sustainable levels. Recent "stress test" results also appear to be broadly assuring. The authorities however, should continue their efforts to improve financial supervision in order to maintain the health of the banking sector and to increase its resilience to a downturn in the current positive trends. In this regard, it is encouraging to note that the authorities are acting on the FSSA recommendations, particularly by sharpening financial supervision towards a better focus on systemic issues, and moving fast in consolidating the regulatory responsibilities. Further efforts to strengthen supervision should focus on forward-looking supervisory exercises and hiring qualified personnel for the single regulatory authority.

Nominal wages in Ireland have been growing rapidly, but this has not affected competitiveness thus far thanks to the higher growth in productivity. Nonetheless, as in the case of all members of the monetary union, it is essential to increase the flexibility of the labor market in order to maintain external competitiveness as productivity growth declines from its currently very high level. This would also help sustain a high rate of economic growth and improve the economy's ability to absorb external shocks. In reforming the labor market, it would be important to introduce more wage differentiation and more flexibility in work arrangements. Adapting the wage-setting mechanism to changing circumstances would also be instrumental in preserving competitiveness and controlling domestic consumption. However, such a reform should strive to preserve the social consensus, which has characterized the Irish experience and contributed to its success. Furthermore, like the staff, we note that an increase in wages is, to some extent, an inevitable equilibrating mechanism in the context of the monetary union. Accelerating other structural reforms, in particular privatization and deregulation of certain sectors, is also essential for the country to sustain a high level of productivity and growth.

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

We commend the authorities for Ireland's impressive economic performance, which over the last seven years has been characterized by exceptionally rapid output growth far exceeding rates in the rest of the euro area. Growth, driven by a combination of strong domestic demand and exports, has transformed the economy in many respects: living standards have converged close to average EU levels; the unemployment rate has more than halved; and substantial budgetary surpluses have been achieved. On the other hand, rapid growth has been accompanied increasingly by strong pressures on resource utilization, suggesting that Ireland might be moving to another phase of its economic cycle. At this critical juncture, we therefore encourage the authorities to focus on easing the transition to a more sustainable growth path, through fiscal and wage restraint and measures to raise potential supply.

While signs of a slowdown are now evident, most indicators suggest that the Irish economy will continue to operate close to productive capacity for some time. Real growth rates for this year and the next are projected to be still well above what is sustainable in the medium term. Consumer price inflation remains well in excess of what is deemed to be price stability and above the euro zone average, notwithstanding the effects of faster productivity growth. After eight years of surpluses, a deficit reemerged on the external current account in 2000. With conditions less favorable for exports, this deficit is anticipated to rise over the next two years. The depreciation of the euro and strong productivity gains in some sectors have served to reduce the impact of rising wage costs. On the supply side, however, labor shortages have become more apparent and the housing market continues to experience strong demand with further upward pressure on real estate prices, albeit at a slower pace.

With monetary conditions generally supportive of the wider euro area economies, discretionary changes in fiscal policy need to be at least cyclically neutral to restrain aggregate demand. The fiscal stance, while not quite expansionary this year, will nonetheless impart a procyclical stimulus to the economy equivalent to about 0.9 percent of GDP through income tax cuts, changes in social security contributions and higher public sector wages. Any further relaxation of fiscal policy is, therefore, inadvisable because there is a risk that relying entirely on wages and prices to induce adjustment could lead to significant ‘overshooting,’ especially if the euro were to appreciate substantially. Over time this could seriously impair Ireland’s competitiveness and its attractiveness as a location for foreign direct investment.

Looking forward, the authorities need to consider a medium-term tax reform strategy that seeks to lower the average tax rate while simultaneously expanding the tax base. Strengthening the budgetary framework, particularly through explicit multi-year revenue plans and expenditure commitments, would also go a long way in fostering a more balanced approach to fiscal policy and in increasing fiscal transparency. In this context, we encourage the authorities to undertake a ROSC to identify areas for improving fiscal transparency.

We take note of the centralized agreements among social partners, the most recent being the renegotiated Program for Prosperity and Fairness (PPF), which involves pay increases and tax reductions to raise net take-home pay. Judging from past wage agreements, there is likely to be pay drift beyond the contemplated increases, especially given near full employment conditions. We agree with the staff that the desirability of these national wage agreements seem less compelling in the future, but note from Mr. Charleton's preliminary statement that the authorities do not share this view. Nevertheless, they agree that such arrangements should adapt to changing economic circumstance while maintaining the broad social dialogue on working conditions and job flexibility. In the meanwhile, we stress the importance of avoiding excessive wage demands in the public sector, given its signaling effect on the private sector, as the benchmarking exercise is likely to initially raise rather than reduce average pay. Perhaps the staff could comment on whether the introduction of a relatively high minimum wage rate has contributed to wage pressures.

We are reassured that given the strong capitalization of the banking system neither the present slowdown nor the softening of the housing market would pose significant systemic difficulties, but urge the authorities to continue to monitor the situation closely. We welcome the steps taken to implement the recommendations of the 2000 FSAP, and encourage further strengthening of the supervisory framework by focusing on the forward looking assessments of overall financial system stability. We look forward to the smooth transition to a single regulator for the financial system early next year.

Structural and regulatory reforms have promoted greater competition in the economy by reducing barriers to entry and improving market access, and we look forward to similar efforts in the public monopolies, particularly utilities, mass transport and the retail food and beverage industries.

In conclusion, we wish the authorities well in their endeavors and take this opportunity to thank them for their progress towards achieving the United Nations' target of 0.7 percent of GNP for official development assistance.

Mr. Rustomjee submitted the following statement:

Once again, the performance of the Irish economy continues to be impressive with an uninterrupted high rate of economic growth since the early nineties. Although GDP growth is projected to slowdown somewhat in 2001 when compared to the last five years, it nevertheless remains remarkably strong, albeit still in excess of what may be deemed to be sustainable in the medium term as Mr. Charleton has acknowledged in his insightful preliminary statement.

Perhaps what is remarkable is that this expansion has been accompanied by an increase in per capita income, with the living standards improving to the point where they are close to their counterparts in the euro area; a decline in the unemployment rate which reached a record low level early this year; a significant strengthening of public finances and the balance of payments; and a sharp reduction in public debt. Although overheating was a point of concern last year, inflation has eased somewhat in part because of the slowdown in domestic demand. It is significant that the inflation differential with European partners has been narrowing even though it remains significantly in excess of the average in the euro zone. Otherwise, this admirable overall economic performance is a testament to the skillful management of the economy for which the Irish authorities deserve to be commended.

Notwithstanding the above, the concise and well focused staff report and Mr. Charleton's very eloquent preliminary statement have highlighted the main challenges facing the economy, including in particular the tightening of labor market conditions and the need to reinforce competitiveness and strengthen the constructive role of fiscal policy in the medium term. Although signs of overheating that were a source of concern last year may have subsided somewhat, the staff has rightly pointed out that medium-term sustainable growth could be undermined by the risks of inflation that could arise from "continued wage increases in excess of productivity growth". Besides, although the near-term prospects remain favorable with GDP growth still expected to be strong and inflation still subdued, the risk of inflation rising in the medium-term calls for vigilance in order to contain potential price pressures in an environment of continued rapid growth and strong pressure on resource utilization. It is important that the authorities should preserve the gains made thus far and perhaps, more significantly, they should reinforce conditions that would help to sustain this remarkable growth under relatively stable conditions.

In this context, it will be essential for the Irish authorities to monitor carefully and to maintain the strong social cohesion which has been instrumental in limiting wage increases, especially in view of the growing labor shortages that could exert upward pressure on wages. Indeed, we agree with Mr. Charleton that the overall social compact has been useful in creating an economic environment that has been central to the achievement of the strong growth. It will also be important to maintain the strong productivity gains which have underpinned competitiveness and also helped to dampen inflationary pressures. To this end, and given the limited availability of traditional anti-inflationary instruments, reforms in wage determination and the focus on fiscal policy would continue to assume a greater role in ensuring sustainable medium-term growth.

The staff's advice for a neutral fiscal stance in 2001 and 2002 is well taken and we agree that cyclical implications of fiscal policy should not be ignored. We are therefore pleased to note that the authorities acknowledge that the demand effects of fiscal policy are not being dismissed. We also see merit in the authorities focus on maintaining medium-term fiscal strength and reducing supply side bottlenecks through tax and spending measures. We would encourage the authorities to reinforce this cautious but constructive role that fiscal policy has played thus far and which has allowed a substantial reduction in public debt . In the meantime and given the stimulus that fiscal policy is still imparting in the current fiscal year, we are pleased to note that the authorities have issued instructions to operating ministries to ensure that spending is kept within budgeted levels.

As regards the performance of the labor market, we continue to be impressed by the sharp decline in the unemployment rate which is now among the lowest in the European economies. At the rate of increase in employment experienced by Ireland in recent years, it is not surprising that labor shortages are becoming more visible. To address the tightening of labor market conditions, we encourage the authorities to initiate, at an early stage, the necessary reforms in the wage determination system in order to better respond to changes in the labor market conditions. While we agree that the current system may still be useful, we urge the authorities to consider introducing more wage differentiation and more flexibility in order to preserve competitiveness. In this regard, we also note the progress being made with deregulation and privatization which would further strengthen competitiveness.

In the financial sector, we have been encouraged by the observation that the vulnerability of the banking system remains insignificant since banks are well capitalized and stress tests indicate continued strength. Nevertheless, we would urge the authorities to remain vigilant to ensure that potential risks are addressed promptly. Accordingly, we welcome the follow up on the recommendations of the FSAP and the further strengthening of the supervisory framework.

In closing, we strongly commend the Irish authorities for their support of official development assistance and their efforts to increase market access for the least developed countries. We are especially encouraged by the substantial increase in ODA as reported by Mr. Charleton and the commitment by his authorities to meet the UN target by 2007. We wish the authorities continued success in the management of the economy in the period ahead.

Mr. Törnqvist and Mr. Sigurgeirsson submitted the following statement:

First, we would like to thank the staff for their balanced staff report which sheds light on important issues at this time of change for Ireland. After many years of registering incredibly strong growth, it appears that the Irish economy is headed downwards to a desirable plateau of strong, but more sustainable growth. Most economies would not welcome a contraction of about 4-5 percentage points in real growth, but for Ireland such a reduction in growth can be seen as a blessing. Given the earlier tendencies of overheating, a continued slide of the same speed next year would of course not be desirable. In addition to relieving demand pressures, a slowdown might provide a true test of the important policy measures of the last decade.

The argument that productivity growth in recent years has in part been driven by the rate of economic growth and will thus be pulled down if growth falters, will also provide an interesting test bed in light of the remarkable productivity growth experienced in Ireland.

On fiscal policy we agree with the staff that while fiscal policy might have been somewhat pro-cyclical this year, the fiscal outcome does not appear to be a problem, in particular in light of the slowdown. This outcome underlines the difficulties in timing the application of discretionary counter cyclical policy. Like the staff, we would encourage the authorities not to aim for a weaker budget in the coming year. We would especially urge the authorities to resist growing expenditure pressures in light of the incipient slowdown as the revenue outturn for 2002 might prove to be lower than expected in the same way as they have been higher than expected in recent years. In this regard, the authorities should be mindful of prioritizing expenditures.

It is quite remarkable to see the growth and the level of corporate taxes as a percentage of GDP, in Figure 17, in light of the low absolute tax rate in Ireland. It would appear that the slowdown in the global economy has not yet hit the Irish economy with full force. Like Mr. Charleton in his preliminary statement, we have some concerns about the effect of the global slowdown on the high tech sectors that have been the driving forces of growth. Businesses have tended to be fast growing and profitable in Ireland. It is likely that these tax revenues will, at some stage, be hit by the shake-up in the technology sector, through a slowdown in FDI, increased financing costs for businesses and trade links, as sales fall in export markets. In addition, large layoffs due to consolidation, as recently seen on both sides of the Atlantic have yet to happen in Ireland. Perhaps, Ireland will remain a lucrative place for investments and manage to avoid the worst of the global economic slowdown in the same way that its performance has exceeded all expectations in recent years. Recent figures, however, confirm that a slowdown is taking hold across different sectors.

Medium-term fiscal policy has had a constructive role to play in maintaining the remarkable achievements in the fiscal position that have been made over the past decade. In principle, we agree with the staff on the need for a strong medium term fiscal framework. We would, however, think that the stability program has filled this function to a large extent. The economic benefits of a more comprehensive framework would be especially important when the external environment is not as favorable. Budgeting will be made easier, especially on the expenditure side. This is important for the decision-making progress given the need for prioritization with the foreseeable need for a sizable investment program in infrastructure, health care and other services. Calls for discretionary tax cuts would also be muted if they would not fall within the realm of the framework. We also think that a fiscal ROSC would be a good idea and could complement the work done in the recent FSSA. We do not see this as an urgent issue, however.

Labor market developments in Ireland have been remarkable in the last decade, as the long term unemployment has fallen from 9 percent in 1994 to just above 1 percent. Ireland's achievements in this regard are all the more impressive when compared to neighboring countries. At the same time unit labor costs have been kept at bay.

The broad national wage agreements have proven a successful set up for more than a decade and the success of the Irish economy owes a lot to their existence. The staff, however, has a point in suggesting that the national wage agreements have outlived their usefulness. While they were useful in bringing down unemployment, they do not appear to work as well in a situation of full employment. The private sector appears not to adhere to these agreements and their purpose is moving toward mostly setting a floor rather than a norm and thus leading to wage drift. It can also be argued that they could lead to discontent in the labor market. The tax cuts that were made to facilitate these agreements, have probably tended to result in higher nominal wages in a situation of full employment. Part of the private sector appears to have more flexibility in the wake of a slowdown. This could be the right time to consider the application of more flexibility on a more general level. Wages have been rising considerably and pressures remain. Public sector increases beyond the PPF norm need to be kept at bay. It would be worthwhile to move further in attempting to apply, or establish, some link between wages and productivity or private sector comparators in the public sector.

Unit labor costs remain at comfortable levels and as the staff notes do not give excessive cause for concern so far. However, there is always the danger of a wage price spiral. Further wage increases at anything close to current rates, especially if accompanied by a stronger euro, could also rapidly weaken the competitive position of the Irish economy. This would especially be true for the so called indigenous industries, for example, if the GBP was to weaken against the euro, this would hurt the important UK exports, leading to unemployment, provided that wages in these sectors would not be flexible enough to absorb some of the exchange rate effects.

While we commend the authorities' effort in recent years, we support the staff in their encouragement to the authorities of the need for further privatization and deregulation. Such measures are very important in order to strengthen competition and uphold the desirability of Ireland as a destination for FDI. This is especially true with regard to product and labor markets.

We note that while Ireland has followed the trend of having a single financial regulator, the authorities have chosen not to have a separate entity, but to consolidate the regulator in the central bank. This means that the insurance industry will come under the supervision of the central bank, which we believe is unusual. Comments by the staff or Mr. Charleton would be appreciated.

We can see the arguments for a follow up for the FSAP at some stage. The unique setup of the international financial sector presents unique challenges for financial supervision. A follow up might also be supportive to the new merged supervisory authorities. Furthermore, despite some moderation, credit growth has remained very high and stresses could emerge in the event that the slowdown would prove to be deeper and become more prolonged than it appears to be today. However, the staff resources available for FSAPs are scarce, and the need to prioritize has been emphasized by this chair and many others. Given the health of the Irish financial system, we would argue that a follow up of the FSAP for Ireland could wait.

Finally, on ODA, we believe that it would not be out of place if Ireland's increased prosperity were to be accompanied by greater generosity.

Mr. Wijnholds submitted the following statement:

Irish economic growth over the past year has continued to be impressive and GNP per capita levels are now above those for the European Union as a whole. The Irish authorities can be commended for achieving such a rapid catch-up, and for sustaining growth over an extended period. Strong growth rates have also allowed for substantial fiscal consolidation while at the same time enabling the tax burden to be lowered. Although there are some signs that output growth may be slowing, growth rates are nevertheless projected to remain well above average EU levels. In the case of Ireland, the present (international) slowdown reduces the risk of overheating, but also increases the importance of continuing with economic reforms. In general, we support the conclusions of the staff that further regulatory reform, budgetary reform, and reform of the wage setting procedures will increase the flexibility of the economy, easing the adjustment to any slowdown in economic growth, and would be helpful in underpinning ongoing economic growth and stability.

From the perspective of the Irish economy, monetary conditions have been relatively accommodative and have clearly contributed to supporting economic growth at very high levels. Economic reforms have also contributed to high growth. Given this performance, it is not surprising that inflation rates are above those of other euro area countries. As the staff rightly notes, external factors have also played a greater role in Irish inflation than is the case for the euro area as a whole.

Although inflation differentials play a role in restoring equilibrium in a monetary union, the current level of inflation poses risks for future economic growth. Wages are a key channel in this respect. The staff illustrates that aggregate competitiveness is unlikely to suffer significantly assuming 10 percent wage growth in the coming year, although local manufacturing firms with lower productivity growth would face greater difficulties. A risk not addressed in the staff note is that such significant wage growth may trigger a wage-price spiral that could have more severe consequences for competitiveness and hence for output and employment growth. The staff rightly notes that an appreciation of the euro exchange rate would pose an additional risk to Irish competitiveness.

Although I agree with the authorities that one should be careful with throwing away something that has worked well for thirteen years, I also agree with the staff that some changes in the wage negotiation process might be warranted. On the one hand, to retain competitiveness, some form of control on wages might remain necessary. On the other hand, a more flexible approach to wage setting that explicitly recognizes the need for greater differentiation in wages and that improves the efficiency of the labor market is necessary. Furthermore, flexibility with regard to wage setting might be necessary to be able to cope with a possible future economic slowdown. The Irish authorities have the difficult task to strike the right balance between flexibility and an uncontrolled and possibly harmful wage development.

The staff expects fiscal policy to be slightly expansionary (on a cyclically adjusted basis) during 2001 and 2002. While we share the staff view that the risks of overheating are not such as to warrant a dramatic tightening of fiscal policy, any stimulus from fiscal policy is worrying in the present Irish setting. Ireland should aim for a neutral policy stance, allowing the automatic stabilizers to work fully. This was also recommended in the Ecofin Council’s formal Recommendation this spring. I am rather surprised that the staff did not mention this Recommendation, which is broadly in line with its own judgment. The authorities need to be vigilant to ensure that spending plans are not overrun, and that any underspending is saved to mitigate fiscal easing. This is particularly important given the staff suggestion that revenue growth may be lower than originally projected by authorities. I was also surprised to see that in the context of the recommendation to provide a medium-term fiscal framework, no mention was made of the Broad Economic Policy Guidelines and the Stability Program for Ireland, which both give guidance with regard to the medium term budgetary developments.

The housing market was a key focus of concern in the previous Article IV discussions. It would be interesting to know whether the staff and authorities consider that the tentative slowdown in the market is likely to be sustained. The staff also notes that banks are becoming more cautious in mortgage lending. It remains unclear, however, what form this increased caution takes (e.g., tighter credit standards, reducing the proportion of the property value that banks are willing to lend, etc.) and how significant it is.

Mr. Wei submitted the following statement:

The year 2000 proved to be another of macroeconomic success in Ireland. It's extraordinary and remarkable economic performance is indeed enviable and commendable, witnessed by a real GDP growth rate of 11.5 percent that was much higher than that of many advanced economies, a very comfortable fiscal surplus and public debt level at 4.6 and 39.3 percent of GDP respectively, and a constantly declining unemployment rate, which reached 4.3 percent last year, lower than most of the euro area countries. The major concern last year, the economic overheating, has been subdued with the welcomed slowdown toward potential output level starting from the later half of last year. Credit goes to the Irish authorities, whose skillful macroeconomic management and structural reform efforts have borne fruit.

I broadly agree with the staff's appraisal and therefore would like to confine myself to a few key policy areas for emphasis.

Amidst the environment of a weaker outlook for the global technology sector and the prevailing slowdown worldwide, Ireland, given its great openness, will experience a period of slower growth with a rate lower than that of the average in the 1990s. This helps to ease the concern over overheating. Considering Ireland's sound fundamentals, there is currently no signs of problems in the Irish economy. However, the fact that past inflationary expectation may take some time to taper off may explain the continued demands for salary increases, although the inflation rate has declined from last year's peak. In this context, the authorities are encouraged to keep a vigilant eye on the development of inflation.

I take notice of the staff expectation of export growth to recover in 2002, which I guess is based on the expectation that the world economy will recover. However, this expectation is subject to great uncertainty, as perceived by many in the recent Board discussion on the United States and other relevant occasions, which may create some uncertainty in the projection of the Irish economic outlook for next year. The risks identified in paragraph 18 of the staff report are a good reminder of the possible deterioration in competitiveness in the coming years. The authorities are encouraged to take these considerations into their policy setting process.

The notably commendable prudent fiscal policy in Ireland has helped keep a good balance between maintaining the fiscal account in a good condition and cushioning the longer-term economic growth target in a way of structural adjustment. The tax structure reform to enhance work incentives is commendable and suitable for preserving and sustaining growth. Broadly keeping the fiscal stance neutral will be sound, as said by Mr. Charleton in his helpful preliminary statement.

The findings of the FSAP as elaborated in Box 2 have justified our view that Ireland has a very trustable financial system and the authorities have always taken a forward-looking approach to maintain its soundness, with a framework for prudential regulation and supervision sufficiently developed to address possible risks. Such a framework will safeguard the Irish financial system's ability to withstand external shocks in the foreseeable future.

Last but not least, I would like to join some other Directors in commending the Irish authorities for their efforts to increase market access for the least developed countries. I am impressed to learn from Mr. Charleton's preliminary statement that the Irish authorities are firmly committed to achieving the 0.7 percent of GNP ODA target by 2007, and would like to encourage the authorities to speed up these efforts given its rather comfortable fiscal account situation.

In concluding, just as Mr. Charleton summarized, "overall the Irish economy has performed remarkably well for a prolonged period without major imbalances arising". Even with the slowdown in the world economy, the Irish economy will most likely enjoy comfortable growth coupled with a lesser amount of pressing inflation. Moreover, the authorities are well aware of the situation they face, and share a broad consensus with the mission on the outlook and policies.

Mr. Le Fort and Mr. Maino submitted the following statement:

We would like to congratulate the staff for an outstanding Article IV consultation report on Ireland that focuses exactly on the right question, analyzing the potential policies and institutional reforms that would ensure a high and sustainable rate of growth. The set of papers submitted by the staff, together with Mr. Charleton's helpful preliminary statement, shed light on the reasons behind Ireland's impressive economic success of the last decade, as well as the future policy challenges.

Ireland's progress of the last decade helps to understand why standards of living can differ dramatically between countries. The divergence in growth rates, when cumulated over a decade have implied that, while Ireland's per capita income has multiplied by a factor of three or four, the world's average has barely increase. These divergences entail more important consequences for living standards than the cyclical business fluctuations that tend to typically occupy most of the attention. Upon reading the report for Ireland, one gets immersed instantly within a puzzle regarding the empirical regularities behind Ireland's economic growth. Is it only luck and other Irish specific factors that lie behind the remarkable and impressive growth performance of the past decade, or are there strong policies and valuable lessons for other countries?

Economic success is, usually, a direct consequence of a series of mutually reinforcing factors, consistently built over a significant period. Ireland's positive medium-term prospects are predicated on a highly competitive environment, flexible labor and good markets, a solid and developed financial system, a low level of public debt, sustainable external accounts and a strong social consensus on economic policy. Nevertheless, we concur with Mr. Charleton that the key factor that sparked the higher growth rate was the attraction of sizable amounts of foreign direct investment that exerted a strong pro-cyclical influence and spurred innovation throughout the economy. We share the thrust of the staff appraisal and we will confine our comments on two issues, namely the medium-term outlook and financial sector policies.

The outward orientation of Ireland's economy favored the attraction of foreign investment and growth during the period of a vibrant global economy. Being a small open economy, Ireland is now suffering the effects of the global slowdown. However, even if a steeper downturn were to strike, the Irish economy seems to be in a strong position to withstand it, thanks to its sound fundamentals. We would like to ask the staff about their views on the implications on growth of a reasonable worst-case scenario for foreign direct investment inflows.

We concur that pressures over excessive resource utilization, are somewhat moderating and that many of the indicators of overheating are gradually fading away. Labor productivity is still evolving steadily, thus maintaining unit labor costs subdued. Also, a reduction in house prices inflation reflects an orderly correction in asset prices and a weakening of a possible wealth effect on private expenditure. Given these developments, we would like to hear the staff views on their likely effect on disinflation and how could they be reinforced by a strengthening of the euro. To what extent, would the effect of a stronger euro compensate the improvement in the trade account that is to be expected from the above stated factors?

The appropriate implementation of the medium-term fiscal objectives seems essential to preserve macroeconomic stability over the medium-term and to contain the risk of pro-cyclical public expenditures. Particularly considering that fiscal policy is the main counter cyclical instrument the authorities have at their disposal. However, with the risk of overheating just fading away and under the current global slow down scenario, we agree with Mr. Wijnholds that a neutral fiscal policy stance would be advisable. The slowdown may favor continue advancing towards an efficient and rationalized tax system, with lower marginal rates, lower VAT rates and excise duties, that would lessen distortions still affecting consumption and investment decisions, and augment work incentives. Therefore, we associate ourselves with Mr. Junguito and Mr. Rambarran to call for a lower average tax rate and for an expanded tax base. Finally, given the role of the educated labor force in maintaining significant competitive gains and a strong export performance, we would like to underscore the importance of reinforcing human capital needs and to pre-fund future social welfare and public service pension liabilities.

We concur with the staff on the need for mechanisms to control the growth in the public sector wage bill. A rapid growth in public sector remuneration might convey an adverse signaling effect on the private sector. Additionally, we invite the authorities to explore the possibility of further expanding privatization and accelerating the divestiture of public monopolies, which would contribute to achieve greater sustainable growth in the medium term in today's competitive globalized economy. By doing so, Ireland will not only consolidate a good track record but, most importantly, the country will turn a path-breaking approach into a genuine model for other countries.

Prudential regulations and financial supervision should remain in sync with the increasing vulnerabilities posed by the housing boom, rapid credit expansion and asset price inflation. We welcome the recently introduced regulations requiring a set-aside for low-cost housing in every new housing development. Together with the natural tightening of lending standards by credit institutions and the actual dampened consumer confidence, there is an increased likelihood of achieving moderation in real estate prices.

Although the safety net built into the euro area supervisory and liquidity arrangements contributed to consolidate a strong financial framework for Ireland, we urge the authorities to remain vigilant of credit risk, particularly in lower resilience-mortgage and consumer lending. By following the staff's suggestion to establish a single regulator and appointing specialized personnel to strengthen insurance supervision, the authorities would address the challenges posed by the need to reinforce the overall framework for prudential regulation and supervision, the potential for contagion from the cross-ownership linkages between banks and insurance companies, and the increase cross-border competition. In any event, last year's FSAP, by confirming the high degree of observance of applicable standards and codes has provided us a reassurance on the health of the well-capitalized banking sector, indicating that its financial and payment systems have remained well managed and developed. We welcome Mr. Charleton's confirmation that the authorities continue to focus on improving the resiliency of the banking system.

In sum, we would like to commend the Irish authorities for their remarkable achievements in managing macroeconomic policies. Provided today's heightened uncertainty in the growth prospects of the world economy, we urge them to focus their efforts towards consolidating the advances that will make possible to sustain a high rate of economic growth over the long term. We wish the authorities every success.

Ms. Alcaide submitted the following statement:

The Irish economy has continued its admirable performance during the last decade with strong economic growth, a markedly increased employment rate nearing full employment, together with a low decreasing rate of unemployment, a rising fiscal surplus and improving debt indicators. It is little wonder that, as it has been mentioned in the staff's report, per capita income exceeded the euro area average in 2000, up from about two-thirds five years earlier. The skillful economic management combined with positive external factors have lead to these impressive results and could serve as an example for other European economies. The challenges ahead for the Irish economy are containing upward pressures on wage increases to avoid losing competitiveness and containing fiscal expenditures to achieve budget results conducive to a sustainable rate of growth.

After many years of booming economy and some concerns of overheating during last year, a welcome economic slowdown is now foreseen for the next two years. In the last year, the combined effects of positive growth, a pick-up in inflation and growing labor shortages have exerted upward pressure on wages. The staff notes that the foreseen wage increases for this year would reflect earlier productivity gains and would not jeopardize competitiveness. As a matter of fact, unit labor costs have been falling sharply due to rapid productivity growth, and as a result, the Irish competitive position within the European Union has kept improving. In addition, with the depreciation of the euro vis-à-vis the U.S. dollar and the sterling pound, it has also stayed competitive with regard to the main external partner countries. Looking forward, the challenge will be to cope with avoiding wage pressures beyond productivity gains in a less favorable economic scenario with a possible stronger euro.

On wage determination, the staff suggests a substantial reform in national wage agreements. According to the staff, they should be reformed to obtain an efficient allocation of labor and wages. Private sector wages should then reflect market forces and public wages should be aligned with wages in comparable private sector jobs. I agree with the staff that the compensation system should be directly related to performance. I am also of the view that centralized wage agreements may impair the differentiation in wages necessary to foster labor mobility towards the more modern and efficient activities. Nevertheless, and as Mr. Charleton points out in his preliminary statement, it cannot be denied that national wage agreements in Ireland have made very positive contribution to the economic environment for the last decade and that, within this framework, the labor market has worked well with an impressive increase in employment of the labor force.

The high growth rates registered in Ireland in the last decade have allowed to achieve increasing fiscal surpluses, leading to simultaneous tax cuts and public debt to GDP reductions. The staff notes, that the fiscal policy stance has been rather expansionary in 2001, and that it risks to do so in 2002 too. Given the still strong cyclical position, the staff's advice is that it would be more appropriate to aim for a neutral stance. While I share the staff's view that the demand effects of fiscal policy should not be denied, the supply side of the policy, through tax cuts and spending in infrastructure, has surely had evident benefits in bolstering economic growth. For the year 2002, with a foreseen reduction in tax revenues, I consider that the policy stance should be tightened through expenditure restraint.

I concur with the staff on the advise to set a medium-term budgetary framework with explicit multiyear revenue plans and expenditure commitments to integrate several economic decisions with fiscal implications and to increase the transparency and predictability of fiscal policy.

It is encouraging to know through the FSSA that Ireland's banking system is well capitalized and adequately liquid and that the framework for supervision is well developed. I concur with Mr. Törnqvist and Mr. Sigurgeirsson that a follow up of the FSAP in Ireland would be welcome at some stage but not in the short term, given the positive performance of the Irish financial sector and the scarcity of Fund resources to conduct such analysis.

Finally, I share the staff's recommendation to accelerate privatization and deregulation for a more flexible and efficient functioning of the economy.

Mr. Kiekens submitted the following statement:

Despite a sharp slowdown in the world economy, Ireland continues to grow at an impressive pace, thanks to the stability-oriented macroeconomic policies and market-oriented structural reforms consistently designed and implemented in a participatory manner during the past 15 years. These policies have made the best possible use of the opportunities offered by Ireland's integration into the European Union and the world economy at large. Hopefully, the Irish success story will soon be emulated by the many accession countries that will join the European Union in the coming years. Again last year, the Irish economy outperformed almost all other EU and OECD economies in growth and employment, and the per capita income has finally caught up with the euro average, from about two-thirds of the average only five years ago.

Last year, the economy showed very clear signs of overheating, particularly in the real estate and labor markets. With output growth reaching nearly 12 percent in 2000, inflation picked up to 6 percent in November 2000, and real estate prices continued to climb by more than 20 percent. The sharp deterioration of the external environment has caused the economy to slow down this year to a more sustainable pace of about half the 2000 growth rate. This slowdown seems already have translated to a cooling down of real estate prices. The labor market takes more time to react and a wage-price spiral may be emerging. Wage growth is expected to be about 10 percent this year, notably as a consequence of the amendment in December 2000 that adapted the wage agreement to higher inflation. The very large gains in cost competitiveness accumulated by the Irish economy during the last 10 years offer ample room to absorb these large wage increases, which are relatively high compared to the rest of the euro area. To some extent, such increases are part of the adjustment process of an overheating economy that is part of a larger monetary union. However, during the next few years output growth is likely to slow down and these wage increases are consequently less likely to be outpaced by even higher productivity increases as they have been during the last five years. In that case, the prolongation of wage increases at such a high level could rapidly damage the very favorable cost competitiveness of the Irish economy built during the last 10 years.

Vigilance is thus required on the wage front. This requires better statistics. I note that there are lags in data availability and a lack of comprehensive data on earnings, including bonuses, which could lead the authorities to overestimate the cost competitiveness of their economy. However, this does not necessarily require the fundamental change in incomes policy advocated by the staff. Because there is a risk that wages may overshoot at a time when the economy is slowing down, I doubt that the time is ripe to exclude wage negotiation in the private sector from the tripartite negotiation about economic policy. Even if wage agreements have constantly been overshot in the past, they still have the merit of offering some anchor for inflation expectations which the authorities should not forego at this time. Moreover, the dialogue that these negotiations trigger among the trade unions, employers and the government about the macroeconomic framework and structural policies has obviously played a useful role in fostering consensus about the policies very successfully implemented by the authorities during the last 15 years. Excluding the most substantial item, namely wages, from the tripartite negotiations may not be the best way to ensure that these negotiations continue to play a useful role in continuously adapting the Irish economy to changes in the world.

In a monetary union, the only macroeconomic tool that is left to the authorities to keep demand in balance with supply is the orientation of fiscal policy. In that regard, it is unfortunate that the authorities chose to damage their almost impeccable medium-term fiscal policy performance by adopting a 2001 budget which was clearly expansionary. To remain consistent with the broad guidelines of the economic policies adopted by the Council of the

European Union in 2000, the 2001 budget should have been contractionary. This inconsistency between the 2001 budget and the 2000 broad economic guidelines prompted the European Council to publish its recommendation to the Irish authorities to tighten fiscal policy in 2001. The procyclical character of the 2001 budget is less of a concern today than at the time the 2001 budget was announced in view of the sharp slowdown, caused by external factors, of growth since then. Nevertheless, the announcement of a procyclical budget at the time the economy was growing at an unsustainably high level was counterproductive. In the latest 2001 broad guidelines of economic policy adopted last June, the European Council still affirmed that the authorities should tighten fiscal policy in 2001 and prepare a budget for 2002 that will contribute to an orderly easing of the pace of demand. It will be most important in the 2002 budget to improve expenditure control and apply clear norms on spending aggregates. After years of strong structural surpluses, and with elections scheduled for the middle of next year, pressures to reduce taxes further or increase spending will be fierce. Some cap on global spending, elaborate cost-benefit analysis for infrastructure spending, and clear benchmarking rules to set the wages levels in the public sector will be helpful to make sure that public money is well spent.

A clear medium-term fiscal framework is obviously helpful in managing public finances on a sustained basis. The staff has made useful suggestions in that respect but does not sufficiently recognize the existence and merits of stability programs in Ireland and other EU countries which do constitute explicit multi-year revenue plans and expenditure commitments. No doubt every country can benefit from a Report on the Observance of Standards and Codes (ROSC) on fiscal transparency. However, in view of Ireland's very sound fiscal position, and the current transparency of the authorities' policies, I doubt that a ROSC on fiscal transparency in Ireland is the best use of Fund's scarce resources.

The very low level of real interest rates in Ireland at present and the strong growth of private credit warrant the utmost attention from the financial supervisory authorities to make sure that financial institutions do not adopt lax lending standards that could undermine financial sector stability. Last year's Financial Sector Assessment Program (FSAP) provided convincing evidence of the stability of the financial sector and the ability of the authorities to supervise it properly. Banks are well capitalized and prudential supervision has been continuously improved to keep pace with Ireland's dynamic financial sector. Further evidence is provided by the micro prudential indicators, the cautious lending standards adopted by Banks in reaction to the slowdown in growth, and the vigilance of the authorities this year. Their vigilance is also demonstrated by their use of stress tests and thematic on-site inspections targeting real estate credits. The stability of the financial sector should continue to be carefully monitored by the authorities and the staff at this juncture when the economy may be shifting to a more sustainable but also substantially lower rate of growth than during the last five years. However, given the satisfactory result of last year's FSAP, and the adequate follow up by the authorities, I am not convinced that an update of the FSAP in Ireland during the next Article IV consultation is the best use that can be made from the scarce resources that the supervisory community puts at the disposal of the Fund to conduct financial sector stability assessments.

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

We commend the Irish authorities for the remarkable growth performance achieved in 2000. Both a strong growth in exports and domestic demand raised the GDP growth rate to 11.5 percent in 2000, taking the average growth rate since 1995 to 9.7 percent. Despite a some slowing down of the growth rate recently, in the wake of a weaker than expected slowdown in the world economy, a 7 percent economic growth in 2001, if realized as expected would be yet another achievement.

The record economic growth in 2000 was associated with increased inflationary pressures. As Mr. Charleton has mentioned, this has added to the risks of a wage price spiral. While the tight labor market condition and increased inflation have led to wage pressures and increase in nominal wages, it is concerting that despite this increase in nominal wages, the unit labor costs have declined owing to strong growth in productivity. Thus the adverse effect of increase in nominal wages on external competitiveness has been offset by an improvement in productivity. Export volume increased by over 20 percent, last year.

A key macroeconomic policy challenge has been to ensure that the high economic growth rate is sustained over the medium-term and the staff report rightly focused the analysis on this major issue. However, inflationary pressures could be continuing due to several reasons. The unemployment rate which has been declining sharply has reached its lowest level of 3.6 percent in Q1 2001, compared to 11.5 percent in 1996, and employment rate is well above the EU average. The amendment to wage agreement under PPF in December to accommodate pressures for increased wages through tax cuts yielding a 25 percent increase in disposable income over the 33 months would add to demand pressures. This and higher inflation have exerted pressures on public sector wages. In addition, the depreciation of the euro and the easy monetary policy could create an inflationary bias.

On the upside risks on inflation, we are pleased to hear that in the context of a monetary union, relative wage adjustments may not exert undue inflationary pressures as this wage adjustment is an equilibrating mechanism toward sustainable growth in cyclically-advanced economies. We would be pleased to hear the views of the Irish authorities on this point as discussed by the staff.

We are in agreement with the staff's suggestion for a neutral fiscal policy stance for this year and at least for 2002, assuming that there will be an improvement in the prospects for world economic growth and the growth in the Irish economy would continue to be above potential. Thus we also endorse "any further tax cuts should be matched by expenditure increases small enough to keep the cyclically-adjusted overall balance unchanged." While we share the staff's concerns that, based on available information on revenue collections, there could be an under-performance on the revenue side in 2001. However, we welcome the authorities plans for holding the expenditure to budgeted levels to limit the expansionary fiscal impulse.

We commend the authorities for the reforms undertaken in the tax system which has been necessary to avoid fiscal drag and reduce tax distortions on labor market. We also recognize that there is scope for further rationalization of the tax system, including the broadening of the VAT base and standardizing the rates to minimize distortionary effects on consumption decisions.

We endorse the staffs suggestions to keep public wages under control by not accommodating 'leapfrog over each other's pay increases' and to be cautious on the benchmarking exercise.

We are pleased that the banking system is sound and the economic slow down will not create significant systemic difficulties. We also join the staff in welcoming the authorities' follow-up on the recommendations of the FASP. We hope that the transition to a single regulator for the financial sector would take place smoothly after the approval of the draft legislation. We also believe, that an update of the FSSA would be useful, given the changing macroeconomic and regulatory environment.

Authorities are encouraged to consider a medium-term framework in the conduct of fiscal policy as it would help to improve the transparency and predictability of fiscal policy, while also helping to improve fiscal prudence.

The staff representative from the European I Department (Ms. Coorey), in response to questions and comments from Directors, made the following statement:

Mr. Le Fort and Mr. Maino asked whether Ireland's remarkable performance was because of luck or Irish-specific factors, or good policies. Last year's staff report had a box on this matter, and it was clear that many factors were significant. Good policies were significant in the form of fiscal consolidation, trade, investment in education, and a wide use of structural funds. Irish-specific factors such as a late baby boom (which made a young, educated labor force available), and the advantage of being an English-speaking country in the euro area which could assist U.S.

multinationals also were significant. Good luck that all of these factors come into play at the same time cannot be discounted either.

On the outlook, Mr. Maino and Mr. Le Fort asked about the implications for growth in the worse-case scenario for FDI. This is a difficult question to answer in quantitative terms, not only because Ireland has very few model parameters estimated for Ireland itself, but also because there are likely to be substantial spillovers on confidence and private spending apart from FDI. Another key unknown is that the wage behavior of the labor market has not really been tested in a downturn for 15 years. So qualitatively, we could say that a short slowdown in FDI probably would not have a significant impact, but certainly a sustained decline in FDI would have substantial implications for output and employment given the openness of the economy.

The MULTIMOD scenario that the staff ran last year suggested a hard landing in the United States, which would have FDI implications. Growth would decline 5 percent and the current account surplus would improve by 4 percent The effects would be substantial, but are hard to quantify.

On the likely effects of disinflation on unit labor costs, reduction in house price inflation, and strengthening of the euro, the weight of tradables in the CPI basket is approximately 60 percent, so that a strengthening of the euro would have a sizeable impact. The staff estimates that the exchange rate pass-through is slightly less than 1 percentage point on the price level for each 10 percentage point change in the nominal effective exchange rate. The impact on house price inflation is less direct. Certainly inflation has subsided markedly. The 12-month inflation in June was only 4.3 percent. That is not much above some of the bigger countries in the euro area.

The overall impact of these three factors on the trade balance of course depends on the net impact on the real effective exchange rate and domestic demand. Trade elasticities again are difficult to estimate because of the rapid structural changes in the export sector and the strong sectoral growth of the multinational exportable output. Nevertheless, we would expect the euro's position would have a significant impact because 62 percent of Ireland's exports go to non-euro countries, and the U.K. is a substantial trading partner. The analysis in Box 1 of the staff report suggests that for the nonmultinational exporters there would be a significant effect.

Turning to fiscal policy and Mr. Wijnholds's observation on the ECOFIN recommendation, the staff report does mention the council's opinion in paragraph 3.

With regard to Mr. Kiekens and Mr. Wijnholds's point on stability programs administered by the European Commission, we recognize the value of the stability programs in setting the right time frame for formulating fiscal policy and for Ireland's existing medium-term framework. However, the staff is suggesting a more comprehensive framework that would yield a more predictable path for fiscal policy. There are two points in this regard. First, in practice, the fiscal projections presented in Ireland's stability program are based on no policy change. Comparing successive stability programs, one can see that the fiscal paths have changed notably from year to year. Now, certainly part of those changes have come from positive surprises on GDP, which shift the entire path. But it is also true that on a cyclically adjusted basis the previous stability program, with a roughly neutral fiscal stance in 2001, clearly was not borne out by the actual 2001 budget which saw 0.7 percent expansion at the time of the budget estimate of the fiscal stance. Second, in the latest assessment of the stability program, the commission itself noted that there was room for improving the medium-term fiscal planning and the way it is implemented. In particular, the commission noted that in 2000 the Irish authorities had shelved their plans for introducing multiannual budgeting, and that the National Development Plan and the public finance commitment in the PPF are not worked out in great detail. The staff agrees with the commission on this point.

On the staff's suggestion of a fiscal ROSC, the staff report mentions some areas where fiscal transparency could be improved, particularly with regard to presentation of budget data. In addition, the authorities would find it a useful exercise in the context of efforts to improve the fiscal framework, which naturally involve broader improvements in fiscal transparency. Indeed, the authorities have expressed some preliminary interest in undertaking a fiscal ROSC, and Mr. Kincaid will address some broader issues on fiscal ROSCs raised by Directors.

Concerning Mr. Wijnholds's point on wages, the staff is not suggesting that strong wage growth this year would not lead to strong wage growth in future years. Indeed, in paragraph 18, the staff report identifies this as a key risk to the medium-term outlook. Paragraph 47 of the staff appraisal says that a key risk is that wages will overshoot levels conducive to continued rapid growth. Paragraph 19 simply states that wages are not overshooting this year, but there is a risk that they could overshoot in the future. In this sense, the staff does not disagree with Mr. Charleton's preliminary statement which makes a similar point. The issue is not that wages might lead to overheating as much as that, in the medium term, wages might affect competitiveness and create a downside risk to growth over the medium term.

On Mr. Kelkar and Mr. Jayatissa's related questions about the authorities' view on relative wage adjustment as an equilibrating mechanism, the staff's impression was that the authorities did not reject this argument, but they stressed their concern that wages could overshoot.

Mr. Junguito and Mr. Rambarran addressed the impact of the minimum wage legislation. The minimum wage was introduced at a time of rising wages in a tight labor market, and therefore some of the effects look small. The ESRI, which is an independent research institute, suggested a relatively small impact, amounting to an increase of 1.5 percent of the total wage bill. Estimates cannot be made on the impact on average wages because Ireland does not have a data series for average wages. An earlier government-commissioned study found that the employment effects of the minimum wage were likely to be limited in the long run—they estimated a reduction in employment of less than 1 percent and an increase in unemployment of 0.5 percentage points, although this was subject to some assumptions about what the dynamics of the minimum wage would be. The effect on consumer prices was estimated at a 0.5 percentage point increase in prices.

Mr. Kiekens noted that given wage pressures, it is not an opportune time to exclude the private sector from wage negotiations. The wage agreements have been helpful in the past, and the staff is not suggesting an immediate abandonment of the current three-year agreement, which expires at the end of 2002. Rather, the staff is proposing a medium-term alternative. It should also be remembered that wages are not only guides for costs, but for the costs that come with the tax cut trade-offs to obtain wage moderation. As the labor market tightens even further, these trade-offs are likely to become not only less effective but costly. In discussions with the authorities and others, it was acknowledged that the wage agreement system should be reformed. Nonetheless, there was little in the way of concrete suggestions. The staff is suggesting a move toward a decentralized system, recognizing that as a small open economy, Ireland cannot set its wages independently of global market forces and needs to let wages respond flexibly in the event of a shock. This flexibility is the key point. The wage agreement system risks that agreements would introduce inertia and hinder an adjustment, especially if people come to regard the wage guideline as a floor rather than a ceiling.

The staff central projection on the housing sector envisages a soft landing where growth gradually settles at 6 percent beyond 2000. This is consistent with labor force growth projections in the long term because of population growth factors. Younger people entering the labor force are fewer and fewer in number. The staff have noted downside risks to the projection, which would also suggest downside risks to the housing market.

On banks becoming more cautious on mortgage lending, we noted in paragraph 10 that this seems mainly because of a tightening of credit standards. For one thing, the central bank has required that banks analyze more carefully prospective borrowers' capacity to repay. The authorities also indicated that banks, on their own accord, are tightening standards because of the weakening outlook. It is too early to say how significant this is, but

> certainly credit growth has slowed down significantly, and the exposure of mortgage finance as a part of total loans is down from 42 percent in 1997 to 39 percent in March 2001.
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> On financial sector supervision, Mr. Törnqvist and Mr. Siegenthaler questioned bringing surveillance of the insurance industry under the central bank. There are examples of an insurance industry supervised by a single regulator; for instance, in the U.K. In fact, last year's FSAP was concerned that because banks and insurance companies were supervised by different entities, it could give rise to possible regulatory arbitrage. The staff also felt that moving insurance provision out of a government ministry into a single regulator would improve the supervisory arrangements in Ireland. On whether it is appropriate for insurance regulation to come under the jurisdiction of the central bank, it should be noted that the central bank in Ireland is no longer making monetary policy decisions and, hence, some of the conflicts that might be expected on that score would not arise.

Mr. Törnqvist clarified that he had not wanted to question moving the financial supervision of the insurance sector under a single regulator. What was questionable was placing supervision of the insurance sector under the central bank.

Mr. Charleton answered that although it was proposed that supervision of the insurance sector come under the central bank, it was a rather complex proposal. In effect, two separate entities had been proposed: a traditional central bank, and a regulatory authority. Each would have their own chief executives and their own boards, but there would be an overall board controlling the whole, and the governor would be the governor of the central bank. The regulatory authority would be kept separate from traditional central banking, but the proposal avoided the practically difficult issues of taking all supervision out of the central bank. It remained to be seen exactly how the proposed arrangement would work out. Insurance supervision had traditionally been a small and underfunded section of a large government department. By placing supervision within the central bank, it should have better resources fortified by a strong supervisory structure.

Mr. Walsh questioned whether wages were not a potential source of overheating. The staff report noted poor wage data for Ireland, particularly for the private sector and nonbasic pay—like bonuses and overtime pay. The staff had said that even despite 10 percent wage increases, overheating was unlikely. But given the lack of confidence in wage data, it would seem that a degree of skepticism was warranted.

Mr. Kapteyn stated that contrary to the tone of the statistical issues annex, the staff report signals that data for short-term surveillance is somewhat inadequate. As an SDDS member, it was not clear if the concern expressed was related to flexibility options under the SDDS. The staff could have been arguing that within the SDDS, Ireland should improve its data to fully meet SDDS requirements in particular categories. Or, the staff could have been pointing out that a lot of data was not covered by the SDDS which would be useful for short-term surveillance. Some of the wage data that Mr. Walsh had just referred to might fall within that category. Clarification on what the data shortcomings are would be welcome.

The staff representative from the European I Department (Ms. Coorey) considered that the 10 percent annual increase in wages was a questionable figure. It came from an estimate by the central bank in their current annual report. There was no overall wage data at all for the current year.

On overall statistics, Ireland was in observance of the SDDS, but more coverage on short-term developments was needed, the staff representative said. The SDDS allows authorities to choose a wage indicator, and the Irish authorities had chosen industrial/manufacturing wages. The SDDS did not require an overall wage index to be developed. For instance, balance sheet data were not required, and Ireland had no balance sheet data. It was difficult to know the overall indebtedness of the household sector, for example. In some sense, the SDDS was a minimum, and in certain key areas, countries might not be producing data useful for monitoring short-term developments.

Mr. Charleton considered that the SDDS did leave gaps, and although there were weaknesses in the data, it had improved tremendously over the past few years. Resources of the statistics office tended to follow what was being required under directives from the European Union, which were not always consistent. Further, it should be noted that because of the tight labor market, the statistics office had great difficulty recruiting qualified staff.

The staff representative from the Policy Development and Review Department (Mr. Kincaid) replied to Mr. Kiekens' comment that a fiscal ROSC for Ireland might not constitute the best use of the Fund's scarce resources. It was a fair consideration, but beyond consideration of scarce resource use, the staff also made an effort to balance the country composition of ROSCs. The Board had reminded the staff in January 2001 during its discussion on standards and codes that a balanced country composition as well as an effective use of Fund resources should be taken into consideration. Fund resources could be conserved in a case like Ireland if the authorities would fill out a questionnaire in advance or undergo a self-assessment. If that were the case, a smaller team from the Fund would be necessary to compile a ROSC compared with other cases. Like Mr. Törnqvist, the staff considered a fiscal ROSC to be worthwhile, but it was not viewed as a pressing issue for Ireland.

Mr. Josz asked if the same policy for ROSCs applied to the FSAP.

The staff representative from the Policy Development and Review Department (Mr. Kincaid) said that in the case of Ireland an update of the FSSA would be worthwhile, but it was also not urgent. The staff would need to take into account other countries that were scheduled to have their first FSAP/FSSA to determine whether the staff resources were available for Ireland to have an update undertaken during the coming 12-month period. Also, from time to time countries that were scheduled for FSAP reviews experienced delays, and it was useful to have other countries as back-ups so that resources were effectively utilized. That back-up role might apply to Ireland.

Mr. Mirakhor suggested that, given the uncertainty of the world economic outlook, it was difficult to determine whether there were no systemic risks to Ireland's financial sector. Although exposures to mortgages had declined, they still were substantial and were spread all over the banking system. If the situation became worse and unemployment started to become a problem, safeguards would be desirable to lessen systemic risk. Having said that, a follow-up FSAP review would be appropriate for Ireland next year because of those uncertainties.

Mr. Couillault requested more information on the rationale for a follow-up FSAP review. For instance, although there was a slowdown in activity in the housing sector, prices were still increasing. And given the changeover to a single regulator for the banking and insurance sectors, an FSAP review might be useful to assess the regulator's performance.

Mr. Josz said that although Messrs. Mirakhor and Couillault's concerns were valid, it was surprising to hear that Ireland was in need of a follow-up FSAP review. Although there were risks, there would always be risks. Balance must be considered, and too many resources had been devoted to the Irish financial sector while other countries were in need of attention.

Mr. Mirakhor expressed concern that follow-up FSAP missions were combined with Article IV consultations which would require an augmentation of resources for Article IV consultations if the staff were to perform a credible job monitoring developments in the financial sector.

Mr. Charleton commented that the authorities would welcome a follow-up FSAP, but like the staff, there was no sense of urgency.

The staff representative from the Policy Development and Review Department (Mr. Kincaid) said that it certainly was possible that an FSSA update for Ireland might occur next year, but various preparations would have to be undertaken and many questions explored with the authorities before a decision could be made. In any case, the staff would keep financial sector vulnerability issues in the forefront of its overall surveillance activities related to Ireland.

The Acting Chairman (Mr. Sugisaki) said that, given the importance of the financial sector in Ireland, the Board would like to be assured that the sector was in good shape, and in that sense an update would be important. At the same time, Ireland had to be placed within the context of the entire FSAP exercise, and the staff would make a judgment based on the total needs of the FSAP. If an update was possible, then it would be done. If the staff found staffing constraints, some other form of review of the financial sector would be arranged.

Mr. Mirakhor made the following statement:

> I join other Directors in their praise of the impressive performance of the Irish economy, and I share the sentiment of Mr. Le Fort and Mr. Maino regarding the quality of the staff report. I particularly appreciated the brief but focused boxes and supplementary notes of the staff report. I also thank

Mr. Charleton for his interesting and, as always, informative and candid statement.

I concur with the staff report's analysis and policy recommendations. Regulatory reform, greater flexibility in wage-setting procedures, and budgetary (particularly the medium-term budgetary framework) reforms would provide greater capacity for the economy to deal with external shocks.

It is welcome that the staff report does not overplay the fiscal expansion and suggest that while it would have preferred a neutral fiscal stance, a cyclically adjusted 0.9 percentage point of GDP, fiscal loosening does not represent a large effective stimulus. Perhaps this mild expansionary impulse provided a cushion against a downturn. However, if growth forecasts of 7 percent materialize, the staff's advice for a neutral fiscal policy stance is appropriate.

My second comment relates to Mr. Charleton and other Directors' concerns about the impact of the global downturn on the Irish economy. As other Directors have noted, a 7 percent growth rate is still enviable, and the slowdown, provided that it does not pick up further momentum, may, in fact, be a blessing. My worry is that the downside risks may turn out to be more than benign. Ireland represents a solid case of a small open economy that engineered a rapid and full integration into the world economy. With skillful economic management and strong social cohesion, it created an environment conducive to investment, stability, and growth. As Ms. Coorey explained at the beginning of the meeting, openness, fiscal consolidation, deregulation, a flexible labor market, stress on human capital, social dialogue, and wage moderation resulted in high growth rates that have surpassed most optimistic expectations. In short, Ireland has managed to derive maximum benefits from the upside of globalization. The worry now is whether it also stands to suffer the most from the downside risks of globalization.

As a small open economy dependent on markets in the United States and Europe, there is a risk that the Irish economy will experience a considerable difficulty from a more severe and prolonged slowdown in Europe. So far it has done well to absorb the effects of the U.S. slowdown, but the situation has worsened in Europe and the U.S. slowdown seems to have lasted longer than initially anticipated. Perhaps the staff are too sanguine about the downside risks in the growth forecast. Although the staff has to work within the confines of the WEO projections—and WEO expects a recovery in Europe—it is difficult under the present circumstances to see how and why. In this same vein, Mr. Wei questioned the expected recovery in exports. The major question is: Should the slowdown in the United States and Europe last longer than expected, do the Irish authorities have the policy wherewithal and instruments to cope with its impact on the Irish economy?

In an environment of great uncertainty, the most important single step the authorities can take is to hone in their ability and instruments to monitor and track the developments in their economy. In this context, I commend and congratulate the Irish authorities for subscribing to SDDS and for improvements in recent years in data provision. At the same time, I urge them to improve the coverage and timeliness of data. Given the dynamism of the Irish economy and the uncertainty surrounding global developments, Ireland should give this matter highest priority. Significant gaps in coverage and timeliness of key data, such as wages, productivity, balance sheets, and budget details, cannot possibly be helpful in monitoring and tracking developments in a dynamic and vibrant economy like that of Ireland.

In closing, I join Mr. Wei and other Directors in commending the Irish authorities for their commitment to achieving 0.7 percent of the GNP target for their ODA and for increasing access to their markets by the least-developed countries.

Mr. Guinigundo made the following statement:

On fiscal policy, we agree with the authorities' argument that the appropriateness of the fiscal stance in Ireland is a function of one's view of potential output. While the staff considers the current fiscal stance as essentially expansionary, we are sympathetic to the observation that there is a mitigating impact on the sharp declines in the ratio of both revenue and expenditure to GDP, large surpluses, and a significant drop in the debt to GDP ratio. In short, as the staff also acknowledges, the stimulus is not large enough to produce a stabilizing correction sometime within the year, but because the stimulus is procyclical, other spending may have to be necessary to cushion the fiscal stimulus. Like the other chairs, we also support the staff advice for a neutral policy stance for the rest of the period until end 2002.

Without doubt, fiscal measures would have the main effect, it should also be considered that fiscal policy has been focused on the supply side. We therefore expect the potential output of the Irish economy to be enhanced by the measures to improve work incentives through reform of the tax structure while easing the remaining structural inadequacies in Ireland through public capital program. It will be useful to know from either the staff or the authorities if the effects of sustaining the policies in this direction could produce short-term macro instabilities or more sustainable medium-term growth prospects.

It is also important for the Irish authorities to keep vigilance over the financial system. The FSAP finding of a well-capitalized and adequate liquid banking system did not lead the authorities to drop their guard but rather drove them to further improve their supervisory and regulatory framework in the areas of stress testing and on-site inspection of key lending sectors. We therefore encourage the authorities to sustain their emphasis in developing forward-looking assessments of the stability of the entire financial system.

We share the view of the staff and the other chairs that the key to addressing external shocks and sustaining medium-term growth in the context of the Irish economy is a well-functioning labor market. While we agree with Mr. Charleton's view that the national wage agreements have served Ireland well all these years, the labor market in Ireland has become competitive and flexible. It is also critical for the long-term goal of sustainable growth that market forces are given more flexibility to determine productivity consistent with adjustment and, in the process, further improve the efficiency of the labor market.

On deregulation and privatization, we are encouraged by Mr. Charleton's assurance that most markets in Ireland are already deregulated while the retail sector is highly competitive. While the staff reports that the authorities find accelerating and broadening of competition-enhancing reforms to be politically difficult, Mr. Charleton argues that the authorities will continue to pursue these thrusts but they do not consider overregulation or lack of competition to be serious constraints on economic growth. For the sake of ensuring long-term viability, our view is that it is wise to pursue the policy of opening the markets and increasingly allowing market forces to work. We have no doubt the Irish authorities realize this is true, but perhaps they simply opted to be more prudent in taking further steps towards accelerated deregulation and liberalization.

Mr. Alosaimi made the following statement:

I congratulate the Irish authorities on the continued excellence of their economic management. The challenge now is to sustain this performance. The focus should remain on improving the growth potential while maintaining a close watch on demand pressures. Here, I will make a few remarks.

Regarding the capacity constraint, the fiscal and structural reforms that have been implemented have been successful in raising the ceiling. Indeed, the focus of tax reforms on enhancing the supply response is welcome. The key now is to further advance these reforms in order to enhance efficiency and increase participation rates. In this regard, additional progress in strengthening competition would be useful. The staff has made some useful suggestions in this regard. Efforts should also focus on enhancing the ongoing return of Irish immigrants. This is a large and well-trained labor source that could greatly reduce supply constraints.

In the fiscal area, the authorities are to be commended for the impressive performance. In addition to increasing the surplus and reducing the debt, they were successful in lowering the tax burden. I am also encouraged by the measures to reduce the tax burden in 2001. However, given the weaker than expected revenue performance in the first half of the year, I agree with staff on the importance of achieving the expenditure targets. Turning to 2002 and the medium term, I welcome the emphasis on maintaining fiscal strength while further reducing supply side distortions.

On incomes policies, I fully share the concerns regarding future wage increases flagged in Mr. Charleton's preliminary statement. Indeed, it is essential to resist granting further high wage increases in 2002 as this could pose a major risk to competitiveness which will be compounded if the euro appreciates. Such a stance, however, may strain the current wage framework. Therefore, I welcome the cognizance that the current type of wage deals need to adapt to changing circumstances while maintaining the approach of broad consensus among the social partners.

Before concluding, let me welcome the increase in ODA and the authorities' commitment to achieve the 0.7 percent of GNP target by 2007.

With these remarks, I wish the authorities continued success.

Mr. Couillault made the following statement:

The Irish economic performance was once again commendable all along 2000. Indeed, last year Ireland experienced its eighth year in a row of strong growth while concurrently reducing the unemployment rate. These results, combined with a fiscal surplus and a balanced current account, leave only a few areas for improvement.

This being said we should keep in mind that success is like Guinness: too much of it may bring headaches the morning after.

True, given the high level of growth achieved in 2000, it is hard to see how the year 2001 could be better. The first signs of the deterioration of the economic outlook are already visible but are far from being worrying. Clearly, such an evolution is not unwelcome and comes at an appropriate time to cool off a bit the overheating pressure. Keeping in mind the extreme openness of the economy with exports exceeding the GDP, one could wonder if the impact of the degradation of the international environment could be stronger than expected. Indeed, if the Irish economy weathered rater well the Asian crisis the international environment was different and in particular the American economy was experiencing a spectacular period of high growth. Therefore we share staff views notes that the recent developments in the United States and in particular in the high technology sector may have a non-negligible impact on the Irish economy.

Since the room for complacency is very narrow in this institution, I would like to make two main remarks.

We share staff's views that an expansionary fiscal policy was not clearly warranted in 2001 and that a stance, at least neutral, could have been a better option to take. The current slowing down of the economy is a blessing in disguise from this point of view and will help to limit the overheating pressures. However, in this context, pressures for increasing public expenditures will be very high and, given the reduction in fiscal revenues, which could be expected due to the weakening of growth, we encourage the authorities to resist these pressures and to adopt a neutral stance for the year 2002.

One area where a word of caution and a call for vigilance doesn't seem to be unnecessary is the evolution of prices and wages. We agree with staff that inflationary pressures seem to be receding and that a higher inflation rate in Ireland than in Europe is not unexpected given the characteristics of the Irish economy but the labor market remains tight and the recent evolution of wages is impressive. Given the apparent uncertainty surrounding the estimation of productivity growth we believe that the evolution of wages should be monitored carefully in order to limit the risks of triggering a wage-setting spiral. Against this backdrop we share staff's views that some flexibility could be introduced in the wage settling process.

Finally, let me say a few words on the financial sector supervision. The recent FSAP mission concluded that Ireland's banking sector is well capitalized and adequately liquid; staff also notes that the decision to establish a single regulator will minimize the risks of a regulatory arbitrage and that the situation on the housing market is more favorable than in the recent past. However staff also recommends having a follow up mission of the FSSA during the next Article IV mission. Having defended constantly the need to have a continuous surveillance of the financial sector, I have absolutely no problem with the idea of organizing such a mission but I would be interested in knowing a bit more on the rationale behind such a proposal. I can see two explanations: one would be that developments in the housing markets are not that reassuring and indeed house prices while slowing down are still increasing; the other explanation would be to have a closer look on the creation of a single regulator and indeed such an evolution is worth monitoring, since so far only limited experience is available on this type of organization.

Staff comments would be appreciated.

Mr. Schollmeier made the following statement:

Once again we commend the authorities for Ireland´s outstanding macroeconomic performance, notwithstanding the recent slowdown. Growth developments have been impressive, leading to a catch-up of per capita income to EU average. The fiscal balance is in surplus and unemployment has reached an impressively low level—especially when compared to other countries in Europe. Since the danger of overheating is fading, the authorities face the challenge of a smooth transition to medium-term sustainable growth rates.

Our views are close to those outlined in Mr. Wijnholds and Mr. Tornqvist's preliminary statements. Therefore, I will confine my further remarks to a few points, i.e., the fiscal stance, wage policy and the financial sector.

Since Ireland is an EMU member, without independent monetary instruments, the authorities have to focus even more on the appropriateness of fiscal policy. Here we would strongly recommend taking a neutral fiscal stance, allowing the automatic stabilizers to work. Especially for next year's budget, we encourage the authorities to resist expenditure pressures. This is particularly important since revenues might be lower than expected in the slowdown phase. On wage policy, we fully share the concerns of other speakers about too generous wage settings, which could jeopardize competitiveness and fuel inflation in the future. Given the prospects of a stronger euro and slower growth rates, wage increases should be closely related to productivity gains. It will not be easy to find the right balance between wage expectations and reasonable wage increases.

We are encouraged by the strength of the financial sector. The banking sector is well capitalized and the stress tests indicate robustness. While we respect the arguments for a follow-up FSAP, we have to consider that the staff resources are scarce and we have repeatedly stressed the need to set priorities, especially taking into account the soundness of the Irish banking system. Mr. Kincaid responded already on this issue.

Finally, I have a brief question to the staff or Mr. Charleton. Paragraph 10 contains a reference to recently introduced regulations requiring set-asides for low-cost housing in every new housing development. This regulation triggered a sharp fall in housing construction permits in recent months.

While acknowledging the strong dampening effects on construction activity as a whole, however, these measures certainly are also a hidden subsidy, which raises questions about the transparency outside the official budget. Comments would be welcome.

Mr. Walsh made the following statement:

On fiscal policy, as growth slows it will be essential for the authorities to maintain expenditure discipline and to stand ready to preempt revenue shortfalls. After such a tremendous period of economic growth, there is likely to be significant pent-up demand for increased quality and provision of public services. In recent years, as growth has overshot projections, the authorities had the cushion of higher revenues than budgeted. As growth slows, shortfalls in revenues are more likely to be observed, and I urge the authorities to manage both public expectations and the fiscal forecasts to take account of such a possibility in order to ensure that medium-term fiscal discipline is maintained.

On the labor market and wage bargaining in particular, I would like to associate myself with Mr. Wijnholds's comments. I question the continuing method of tripartite wage bargaining arrangements. When these agreements were first conceived, Irish unemployment was among the highest in the European Union; labor force participation, and particularly female participation, was low; and for much of the 1970s and 1980s, Ireland's predominant export had been labor. Wage restraint under such circumstances should not have been too hard to deliver. Now, though, it may prove far harder. After significant job generation, unemployment is at record lows, participation has risen sharply and now exceeds levels commonly seen throughout the European Union, and economic growth has brought much of the Irish diaspora home, accompanied by significant additional inward migration.

Maintenance of the tripartite wage bargaining structure under such circumstances is likely to be difficult. Given the paucity of wage data for Ireland, and particularly for the private sector on things like bonuses and overtime pay, it is not even clear that the current wage round has had a restraining effect on much of the economy. Rather than suppressing wage differentials, reducing flexibility, and building up significant pockets of wage pressure, the authorities may be better advised to consider developing an exit strategy from such forms of bargaining arrangements. During good times, much like we advise countries with pegged exchange rates to put in place structures that would allow smooth transition to a float, the Irish authorities would be well-advised to work proactively now to prepare the ground to move away from the tripartite scheme, rather than risk a wage explosion should the current structure fall apart.

Looking ahead, I would be interested in the staff's or Mr. Charleton's view on the likely outcome and/or impact of the public service benchmarking report due to be released in June of next year. Given the sizable pay increase that was made to the Garda (the Irish police force) a few years back, and the ongoing pay dispute which the public sector now faces with the teachers, there must be a concern that this body's findings could trigger a ratcheting up of wage pressures.

Mr. Santos made the following statement:

Let me start by thanking the staff for a job well done. The report provides us with an in-depth analysis of the challenges that have to be successfully faced by the Irish authorities if the success story of the past decade is to continue well into the future. Among these, we would underline the need to move to a more decentralized system of wage bargaining and to adapt fiscal policy to a less buoyant environment, where room for further tax cuts has been substantially exhausted and consequently further expenditure initiatives should be pondered even more carefully. As for the more immediate outlook, the arguments presented lead us to believe that although the fiscal stance might not be completely in line with the current needs of the Irish economy, there is a strong likelihood that a soft landing from the regime of very high economic growth is well within reach. A good indication of that is the reduction of inflation in recent months.

Let me now expand a bit, first on macroeconomic prospects in the near future and finally on changes in the policy framework needed to enable the Irish economy continue its success.

As for near future prospects, it is clear that the stimulus provided by the current fiscal stance has been substantially tempered by the soft external environment, thus reducing pressures on resources and the chances of overheating. Yet, it should be recognized this offsetting effect is somewhat fortuitous as it was not fully anticipated at the time the budget was designed.

Beyond the immediate future, in view of the limited number of instruments available to deal with specific cyclical conditions, and the Irish conditions are indeed very specific, we believe that the free play of market forces should help address any remaining tensions in the economy. This is particularly relevant in the current juncture as the shift of ECB's monetary policy to an easing mode does not serve the needs of the Irish economy. Hence, any stronger wage inflation, by weakening competitiveness and contributing to a desirable redistribution of demand across trading partners, should be seen as part of the normal adjustment mechanism.

In these circumstances, in view of the high share of trade outside the euro area, any future appreciation of the euro, together with the increase in short term real interest rates reflecting the fall in inflation, could contribute to this adjustment process. The consequent tightening in monetary conditions would lessen the burden placed on fiscal policy as the main tool of macroeconomic stabilization.

That said, it is important that the big wage increase awarded this year be regarded by wage earners as a one-step adjustment, geared to put wages more in line with the steep productivity growth of past years and to promote a fairer sharing of the growth dividends between labor and capital. Hence, this adjustment should be seen as a special deal and should not feed wage expectations.

As for the contribution of fiscal policy to a desirable soft landing, while the slightly expansionary fiscal stance may not carry major consequences due to the weaker external environment, it is important to prevent a further fiscal impulse in 2002. Moreover, like Mr. Kiekens, we believe that expenditure control should be a priority and the quality of public expenditure should be preserved. Indeed, in addition to the improved fiscal position, the decline of revenues and expenditures as a percentage of GDP is also an achievement to be noted. This is particularly remarkable in the case of Ireland as rising per capita incomes are normally associated with bigger government, reflecting the superior good character that is normally attributed to public spending. A leaner government no doubt gives Ireland a competitive edge over its European partners.

Finally, a comment on the changes in the policy framework needed to allow the economy to continue its success story. In the future growth will be predominantly determined by productivity developments and less by factor accumulation, as the pool of available labor has been substantially reduced. In these circumstances, the new framework should help promote overall economic efficiency through a better allocation of labor resources. In our view, a more decentralized wage bargaining system, that allows wage differentiation across sectors and firms to better reflect different conditions, meets this efficiency test. Furthermore, in a situation where productivity growth may vary across sectors, a more flexible wage setting framework may help sectors with different productivity growth to coexist. Of course, it is also important that economic agents adapt to this new framework, namely by tying their demands and offers more closely to productivity developments in their respective sectors and firms, than was the case in the era of multiannual and national wage agreements.

Ms. Brukoff made the following statement:

This year's report describes the spectacular economic boom Ireland has enjoyed in recent years, underpinned by strong policy implementation by the authorities. It also shows the strains that have begun to emerge such as tight labor markets, persistent high inflation, and rapid real estate price inflation, to name a few.

Faced with these challenges, the global downturn comes at a rather convenient time for Ireland. The economy was showing signs of overheating late last year, but with monetary policy in the hands of the ECB and clearly too easy for the Irish economy, it was unclear how the authorities were going to address supply-side pressures brought on by the very strong pace of economic activity.

Staff echoes criticism leveled at Ireland earlier this year by ECOFIN for approving a relatively stimulative 2001 budget given the overheating economy. Here we have two observations.

First, it may be fortuitous that the policy's effects come on line just as the global economic slowdown saps Irish exports and investment in the high-tech sector.

Second, while the staff is probably correct that a more neutral fiscal stance was warranted this year, it seems hard to argue that there was no scope for tax cuts, or for increased welfare expenditures going forward, in view of Ireland's substantial budget surplus and the country's low and falling debt/GDP ratio.

That being said, the authorities will nevertheless have to be vigilant about maintaining fiscal prudence going forward. Here, the staff's recommendation for developing an explicit and comprehensive medium-term budget strategy is correct. Such an approach will be critical for reconciling conflicting future demands on scarce budget resources.

The main area of concern ahead for Ireland's economy is the course of public wages, and Mr. Charleton makes clear in his statement his authorities' concern that higher inflation could become embedded in wages and start an inflation spiral that would eventually erode Ireland's competitiveness gains of recent years.

Innovative approaches, such as the benchmarking exercise or modifying aspects of future national wage agreements, should be pursued. However, their effectiveness will have to be monitored carefully and alternative approaches introduced if these measures prove insufficient to contain wage pressures and support competitiveness.

Finally, on the issue of further deregulation and privatization of the Irish economy, we take the view that a slowdown in growth in the future would make the introduction of policies that broaden and accelerate privatization and regulatory reform both more important and more difficult politically. Hence, the government should take advantage of the opportunity presented by current favorable economic conditions to push ahead with reforms aimed at increasing competition. A useful start could be made by implementing recent recommendations on regulatory reform from the OECD.

Mr. Ondo Mañe made the following statement:

> At the outset, the Irish economy's decade of uninterrupted high growth is impressive. In the more recent period, income overheating followed by a labor shortage, and a sharp increase in asset prices, seem to have abated. Inflation has remained under control over most of the period. Overall, the Irish authorities are to be commended for their admirable performance. As I broadly agree with the approach of the staff appraisal, I would like to take this opportunity to associate myself with the comments presented in preliminary statements by Mr. Kelkar, Mr. Kiekens, and Mr. Rustomjee regarding the reform undertakings in the tax system and the need to consider a medium-term framework in the conduct of fiscal policy.
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> On inflationary issues, the underlying threat of inflation remained in line with the authorities' expectations. Nevertheless, I would urge the authorities to exercise caution and take steps to prevent any constraints on the remarkable growth by inflation pressures.
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> With regard to wage issues, we agree that the wage agreement and the Programme for Prosperity and Fairness have been important factors for wage moderation and stability, and has contributed to impressive economic growth. However, the wage agreement system has to adapt to changing circumstances, I call on the authorities to introduce a degree of flexibility with regard to public sector wages, with elimination of tax trade-offs.
>
> With regard to fiscal policy, the Irish authorities have followed a prudent stance over the past year, comfortable fiscal surpluses have been achieved, helping the debt-to-GDP ratio to decline significantly. I believe that the staff's recommendation for a prudent stance seems justified. I also share Mr. Kelkar's view in encouraging the authorities on their plan to hold the expenditures to projected levels to limit the expansionary impulse.
>
> Finally, on the support of ODA, I welcome the authorities' commitment to meet their target for 2007. With these remarks, I wish the Irish authorities every success in their future endeavors.

The permanent observer from the European Central Bank (Mr. Grisse) made the following statement:

> The Irish economy shows, and has shown for many years, the kind of dynamism that would be desirable to have in the larger European countries. What impresses us most is the flexibility of the economy and especially the flexibility of the labor market. This employment performance, albeit with constrained unit labor costs, is indeed a tremendous achievement, so we congratulate the Irish authorities.

As far as monetary policy and the inflation record is concerned, we broadly agree with the analysis of the staff. Our concerns are, as Ms. Coorey also stressed, related more to the expectations. Although matters seem to proceed in the right direction at present, increased wage rounds at a magnitude of 10 percent for years must be embodied in people's expectations. In this respect it is worrisome that public sector wages could take on an intrinsic dynamism, not to mention that the period of renegotiation of the present agreement has shortened to nine months.

Credit growth rates peaked in 2000 at 30 percent and came down to 20 percent. Combined with pressures from wages, there is still a considerable threat for loss if competitiveness. Although, we see this potential loss in competitiveness as a normal outcome needed to make adjustments within the monetary union.

Finally, let me stress that the ECB fully shares the recommendation of the ECOFIN council on the fiscal stance, and we are also fully in support of the decision to establish a single financial regulator. The attitude the Irish authorities show toward the Fund's FSAP is impressive; they cooperate and simply do what has to be done.

Mr. Kapteyn made the following statement:

It might be useful in the staff report for the next Article IV consultation to look at cross-country data for Europe to see where public wages stand in other countries. It must be asked if these tripartite structures for wage determination have outlived their usefulness. It is an area of interest to the Netherlands also, as it is difficult to get rid of centralized wage bargaining agreements. There is a lot of resistance from political groups and unions because more flexibility means a more market-based way at determining wages.

In the Netherlands what has been maintained is the social structure that comes with wage agreements. The government, the unions, and the employers come together and continue to talk about economics in general, and wage and price developments. But decisions are no longer taken at these meetings. The decision-making powers have been removed from these structures while the social dialogue remains. This has come about through an incremental process, and the degree of flexibility that would be desirable has still not obtained. Mr. Walsh is correct in saying that the it would be easier to change laws before any slowdown might make matters more difficult.

Mr. Josz commented that if public sector wages were not raised, many countries would face the same kind of problem experienced by Ireland—the difficulty to hire qualified statisticians to keep good statistics. The benchmarking exercise the authorities are undertaking is useful; the aim should not be to keep the level of public sector wages as low as possible, but to create an adequate objective salary scale in the public sector. In an economy where private sector wages increase by 10 percent every year, holding down public sector wages may damage the competitiveness of the economy because the basic functions of government will not be exercised properly anymore.

The staff representative from the European I Department (Ms. Coorey) addressed Mr. Guinigundo's question on whether fiscal measures to improve the tax structure and to improve infrastructure would generate short-term instability to obtain the benefits of long-term growth. The Irish authorities considered that the long-term benefits were substantial. The staff thought that the short-term demand effects should not be ignored. Since Ireland was a part of the monetary union, the offsetting movements that interest rates and exchange rates would normally have taken did not take place as the fiscal sector expanded. Therefore, it was important structural improvements be accompanied by other measures to keep a broadly neutral stance, as long as circumstances were more or less not extreme, either on overheating or recession. Nonetheless, there certainly were long-term benefits from the kinds of reforms that the Irish authorities had undertaken.

On whether requirements to build low-cost housing in new developments constituted a subsidy, those requirements did impose somewhat nontransparent inefficiencies into the market by trying to achieve social objectives through regulations. Not only were contractors required to build low-cost housing, they were also required to evenly distribute that housing across new housing developments. Because of that requirement, the contractors could no longer set prices.

Mr. Charleton made the following concluding statement:

> A number of Directors referred to public sector wages in general. We have had persistent on-and-off strikes in our secondary schools since last September, and even though the fiscal surplus is large and the teachers are traditionally a strong union, they have made no progress with their various strikes. Not only have they not made progress, but the public attitude is firmly against the teachers on this, and reveals a change in attitude of the public to public sector wages and to the strong public sector unions. The public has taken the view that teachers will have to wait and see what the benchmarking exercise brings up. None of us know exactly what the results will be, but it certainly is an innovative attempt to address these issues. Those who think the benchmarking exercise just means everyone will get more money are going to be severely disappointed. By the time the report will be submitted next spring, the fiscal surplus will have been declining. The government will get the report but will not address its contents until after the general election to be held in May or June.
>
> Whether centralized public sector wage agreements have outlived their usefulness is a matter of vigorous debate in Ireland. I suspect the agreements do not make a great difference one way or the other. What is going on in the economy takes precedent. The agreements have become institutionalized and

a part of the way people tend to do things. There is an element of what might be called "ritual" about them. At the end of the day, in any society, rituals are important. But the economy is probably going along as it would be without those rituals. While they might not result in a great deal of good, they also do not do much harm.

On the short-term damaging effects of the expansionary fiscal policy, it must be asked that if the public capital program is being expanded vigorously, is demand being stoked in an overheated economy? There is an active public investment program, and the bit that amazes me most about Ireland is that it has grown so much with such an abysmal infrastructure. This is difficult to understand. The government is keen to push forward with capital development projects by expanding public infrastructure to expand the capacity of the economy. It is possible that adds to demand in the short run, but British and Dutch companies are building the major road projects. Ireland has been successful because it knows how to use the European market, and how to operate as a small country within that market.

On fiscal policy expansion and breaching the broad economic policy guidelines of the European Commission, fiscal policy was a little bit expansionary. But the essence of this dispute between Ireland and Brussels had little to do with the fiscal policy stance. The EC did not appreciate when the Irish authorities cut taxes. The phrase "unfair tax competition" is often used, and the argument more concerns that issue than the stance of fiscal policy. An expansionary fiscal policy in Ireland is not going to have a big impact across the whole of Europe. Further, issues of taxation are entirely a matter for the Irish authorities. Local taxation is a matter for the national governments.

On the low-income housing scheme, Ireland used to be relatively poor. There has been a lot of income wealth generated in the past ten years, and society has become more divided. There has been a long tradition of public provision of housing or public subsidization of housing for lower income families. This is common in many countries. There is a social policy adhered to by the authorities to allow those who have gained most in the economic boom to live comfortably in their ghettos while the less-well-off live uncomfortably in their ghettos. The government did introduce a policy that 20 percent of any housing development has to be set aside to be administered by the local authoritiy for what is called social housing. The initial impact in the first half of 2001 seems to have been rejection by builders to construct the houses. Something caused the housing supply to slow down. That was against all expectations. Everybody was saying the supply of housing should be speeding up while it slowed quite noticeably. It is hard to know what the effects of this are, but the message seemed to be that. By tradition, the builders are voters and supporters of the party in power. The construction industry are fully with the present government, always by tradition. The builders are thinking that if they slow things up, the present government will change the regulation. Yet it is quite clear that this regulation is not going to be changed, that my authorities are not apologizing for it, and that it is a policy that they are not going to permit social divisions to get wider and wider. In any case, house prices and property prices are so high that builders will still do extremely well by building houses.

Mr. Josz stated that he disagreed on Mr. Charleton's interpretation of the fiscal policy stance. It was important, especially for small players in the monetary union, to recognize that there were rules that came with the stability pact. All members were supposed to use their fiscal policy to contribute to global stability. While only looking at Ireland's situation, it could be asked whether Irish fiscal policy posed a threat to the stability of the union. It set a precedent, and if the larger countries of the monetary union behaved like Ireland had, there would be trouble.

Mr. Charleton replied that the authorities would take up the issue seriously when the commission reprimanded four other EU countries for their stance on fiscal policy.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for Ireland's outstanding economic performance over the past decade and a half, during which income and employment grew rapidly and unemployment declined to very low levels. A substantial strengthening of public finances, a welcoming policy environment for foreign direct investment, and sustained improvement in competitiveness have contributed to these remarkable achievements.

With resource utilization at high levels, Directors welcomed the moderation in demand and output growth in 2001. They noted that the inflation differential vis-à-vis the euro area average has declined and that house price inflation has abated somewhat. Directors viewed the recent acceleration in wage increases as largely reflecting a catch-up with earlier productivity gains and, therefore, unlikely to harm competitiveness in the near term. However, they warned that if wage increases were to continue to exceed productivity growth, competitiveness could decline and growth could slow over the medium term—though Directors observed that, in the monetary union, some relative wage adjustment was to be expected since it was a mechanism to help bring output growth back to a sustainable path.

Directors observed that the economic outlook remains broadly favorable, but the authorities face a number of challenges in ensuring a smooth transition to a lower, more sustainable rate of growth. Given Ireland's openness and the importance of foreign direct investment in high technology, the deterioration in the global outlook—especially for the technology sector—poses considerable downside risks. Wages and prices will have to respond flexibly to any new adverse external shocks, and the authorities should remain alert to potential stresses in the financial system, although any possible stresses appear manageable at this stage.

Directors agreed that the fiscal stance in 2001 should have been neutral rather than expansionary. Hence, public expenditures should be held tightly to budgeted levels and any underspending saved to mitigate the fiscal easing. Most Directors considered that, provided serious overheating or recession remain unlikely, the authorities should aim at a neutral stance in 2002, and allow the full play of automatic stabilizers. They stressed the difficulty of managing a counter-cyclical fiscal policy in a small open economy. Directors recommended that any stimulative effects from improving the structure of taxes or expenditure be curtailed through offsetting measures elsewhere in the budget.

Directors welcomed the authorities' efforts to improve the tax structure. They noted that cuts in marginal tax rates and the broadening of the rate bands have contributed to reducing labor supply distortions. They suggested that there may be scope for further rationalizing of certain taxes. In particular, the social security tax regime could be reformed so as to take into account its interaction with income taxes, and the base of the VAT could be broadened and its rates standardized.

With regard to expenditures, Directors underscored the need to keep public sector wages under control. They welcome the benchmarking of public pay to private sector pay, but cautioned that offsetting budget measures may be needed if this leads to large increases in the public sector wage bill. They agreed that increased capital expenditures on physical infrastructure are clearly needed, but in view of the short-term capacity constraints, rigorous appraisal and prioritization were essential.

Directors recommended the introduction of a medium-term fiscal framework, building on elements already in place, to help clarify medium-term policy objectives and increase the transparency and predictability of fiscal policy. They stressed that any increases in public resources to specific sectors, such as health and education, should flow from a comprehensive analysis of alternative means of addressing public needs, including through greater private sector provision of such services. In addition, Directors suggested that medium-term budget plans should be accompanied by a strengthening of administrative mechanisms to hold spending departments publicly accountable for the delivery of agreed services within budgeted amounts. To identify areas where transparency can be further improved, Directors suggested that the authorities undertake a Report on the Observance of Standards and Codes (ROSC) on fiscal transparency at a suitable time.

Directors urged the authorities to be vigilant regarding systemic stresses in the financial sector due to slower growth and the softening of the housing market. They welcomed the efforts to implement the recommendations of last year's Financial Sector Assessment Program (FSAP) report and supported further strengthening of the supervisory framework by focusing on forward-looking assessments of systemic stability. Directors noted that draft legislation establishing the single regulatory authority should be approved quickly and the specialized personnel needed to strengthen insurance supervision increased as soon as the single regulator becomes operational. In view of the changing macroeconomic environment and the introduction of the single regulator, many Directors suggested that an update of the Financial System Stability Assessment (FSSA) may be useful next year, but others consider that this should not be a priority given resource constraints in the context of the overall FSAP program.

Directors observed that a number of structural reforms are desirable to help secure continued vigorous growth over the medium term. They agreed that the national wage agreements had facilitated wage moderation in the past, but considered that, in a tight labor market, such agreements may become less effective and may even act to set a floor, rather than a ceiling, on wage increases. Many Directors felt that such agreements could be a source of inflexibility in the event of an adverse shock. Directors also questioned the appropriateness of trading tax cuts for wage moderation in a tight labor market and in the face of increasing demands for public spending. While seeing the value of social dialogue on such issues as working conditions and job flexibility, most Directors suggested that the national partnership approach be reformed to allow private sector wages to be fully market determined, and public sector pay to be aligned with wages in comparable private sector jobs. They stressed the need to develop, over time, a broadly accepted and comparator-based system for determining public sector pay that would allow for greater pay differentiation.

Directors urged the authorities to strengthen competition through privatization and deregulation. They noted that greater competition, especially in sectors traditionally characterized by public monopolies such as utilities and mass transport, would also increase wage discipline. They noted that scope exists for further deregulation and stronger enforcement of existing regulations in the retail food and beverage sectors.

Directors noted the recent improvements in data reporting but called for further progress in improving the coverage and timeliness of data necessary for monitoring short-term developments—notably wages, productivity, and balance sheets, and some aspects of budget presentation.

Directors welcomed the increasing Official Development Assistance and encouraged the authorities to make further progress toward achieving by 2007 the U.N. target of 0.7 of GNP.

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

4. ETHIOPIA—POVERTY REDUCTION AND GROWTH FACILITY—REVIEW

The Executive Directors considered a staff paper on the first review under the three-year arrangement for Ethiopia under the Poverty Reduction and Growth Facility (EBS/01/108, 7/5/01).

The staff representative from the African Department (Mr. Tahari) submitted the following statement:

Information provided by the authorities since the issuance of the staff report on Ethiopia's first review under the PRGF arrangement (EBS/01/108) indicates that the federal government budget for 2001/02 was passed by both the cabinet and parliament. It provides for a defense allocation of Br 3 billion (5 percent of GDP), Br 300 million lower than envisaged in EBS/01/108. Also, the prohibition of payment of interest on commercial banks' current account deposits was lifted by July 15, 2001, as per the letter of intent.

With regards to the quantitative benchmarks for end-June 2001, the ceiling on new nonconcessional external debt contracted or guaranteed by the public sector was met, as was the continuous performance criterion on the nonaccumulation of new external arrears. However, preliminary data indicate that the floor on the Net Foreign Assets (NFA) and the ceiling on the Net Domestic Assets (NDA) of the National Bank of Ethiopia were not observed. The program benchmarks were calculated on the assumption that a US$150 million balance of payments IDA credit would be disbursed before end-June 2001. In the event, the IDA credit was disbursed a few days later, on July 9, 2001, and calculations indicate that both the NFA floor and the NDA ceiling would have been observed with large margins if the disbursement of the IDA credit had been disbursed as originally anticipated.

Mr. Rustomjee submitted the following statement:

My Ethiopian authorities are in broad agreement with the staff assessment on the performance of the Ethiopian economy under the first annual arrangement under the Poverty Reduction and Growth Facility. They are appreciative of the ongoing policy dialogue with the Fund and the valuable advice and assistance given by the staff.

The positive achievements under the 2000/01 program are well documented in the staff report. In the context of steady progress towards peace with Eritrea, the authorities have strived to achieve the macroeconomic and structural reform objectives set under the PRGF program. All quantitative and structural performance criteria and benchmarks for March 2001 were observed, some with a substantial margin. There are also encouraging signs that policies for the remainder of the program period will, in the same way, be implemented successfully, thus paving the way for the Board's revalidation of the decision point under the enhanced HIPC Initiative, in October 2001.

Economic activity recovered strongly compared to the previous year, aided mainly by a bumper cereal crop. Hence, real GDP growth for 2000/01, although slightly below the program target, is estimated at a robust 7.5 percent, and with inflation decelerating to minus 2.7 percent, against a projected target of 5.2 percent.

Fiscal performance was in conformity with the program target as the small shortfall in revenue was more than offset by expenditure cuts, especially in nonpriority areas. Tax policy reforms are being carried out as planned in addition to the overhaul of tax administration. Special attention has been paid particularly to expenditure restraint, given the delays in the disbursement of pledged foreign assistance. Against this background, and given the increasing demands of the social sectors, a significant step has been taken in reallocating an amount equivalent to 0.9 percent of GDP, from defense in favor of these sectors.

Monetary aggregates were contained well below the program estimates. There has been an important move towards the liberalization of interest and exchange rates. Increased use is being made of indirect instruments for monetary control. In addition, trade restrictions and administrative controls on access to foreign exchange were lifted toward the end of 2000.

The authorities also pressed on with the process of structural reforms, especially with further intensification of the privatization program. The planned judicial and civil service reforms are also expected to gather pace as the medium-term reform agenda moves forward.

Looking ahead, my authorities are fully committed to pursuing the necessary efforts aimed at consolidating the macroeconomic stabilization gains and with the required structural reforms to move towards a path of strong and sustained growth in an environment of relative price stability and one with impact also on poverty reduction. Among the various measures being considered to this effect, they will continue to pay special attention to ensuring a better allocation of resources accompanied by improved efficiency in their use. The authorities intend to persevere with further liberalization of the economy, remove the remaining structural impediments to growth and development, as well as expand the role of the private sector in the economy.

While my authorities are persuaded that the overall fiscal deficit for the whole program year would be lower than projected, they are convinced that further fiscal consolidation will continue to be required, as it remains a crucial element of the adjustment program. As a result of the authorities' quick response in adjusting expenditures to revenue underperformance, the overall budget deficit for 2000/01 will be limited to 6.5 percent of GDP, resulting in a downward revision of the original target. The authorities intend to continue with their cautious spending policy in 2001/02 and are committed to enhance revenue performance to the equivalent of 19.2 percent of GDP, mainly on account of increased tax returns. In addition to the full year impact of the tax reforms carried out since January 2001, emphasis has been placed on further strengthening the system of tax administration, including through the recently established large taxpayer unit, and submission of the new VAT law to Parliament by October 2001. The authorities intend to maintain tight control over expenditures at all levels of government while giving primacy to increased spending in poverty-related areas. Their commitment to enhance budgetary transparency is also reflected in the determined efforts to improve the tracking and reporting mechanisms for government expenditures. As a result of these combined efforts, the overall fiscal deficit for 2001/02 is expected to be reduced to 8.2 percent of GDP, compared to the original target of 8.8 percent.

Monetary policy will remain prudent to support the fiscal stance, keep inflation under control and strengthen the international reserves position. Interest rates will continue to be market determined. The significant reduction in public sector net indebtness has opened the possibility for credit expansion to the private sector. The authorities intend to carry out comprehensive reforms in the financial sector, to be implemented in the medium-term, which are aimed essentially at strengthening the regulatory and supervisory framework, improving the efficiency and soundness of the banking system and inducing greater competitiveness in the financial system. Given the role and importance of the Commercial Bank of Ethiopia (CBE) in the banking system, the authorities intend to enter into a management contract with a reputable foreign institution that will have the responsibility of turning the bank into an economically viable financial institution.

The authorities are fully aware that structural reforms are critical to improve the efficiency of the Ethiopian economy to enhance its growth potential and contribute to their ongoing efforts for reducing poverty. In this context, and in collaboration with the World Bank, the authorities efforts will be focused on reforming the civil service, strengthening the public expenditure management, and promoting private sector development and export competitiveness. They also intend to press ahead with the privatization program initiated in 1995, with a view to concluding this program by 2003/04. Moreover, further progress towards trade liberalization is envisaged with the anticipated import tariff reduction and simplification of its structure. To ensure that the envisaged structure is the most effective for their economy, the authorities are proposing to carry out a study on effective protection to be concluded by March 2002.

In order to be able to benefit from substantial debt relief under the enhanced HIPC Initiative, the authorities are already engaged in preparing the full PRSP, which they are hopeful of completing by the first half of 2002. They expect to develop the poverty reduction strategy with the full participation of civil society as well as their development partners. The strategy, apart from establishing a development plan and examining its impact on poverty reduction, will also be analyzing the best approach to address the daunting challenges imposed by the spread of the HIV/AIDS pandemic, as Ethiopia hosts the third largest population in the world living with the virus.

The Ethiopian authorities have demonstrated their firm commitment to adjustment and reform and intend to maintain the same commitment over the entire medium-term program and beyond as necessary. The international community's support to their efforts is critical to enable the authorities to meet the program objectives. The completion of the present review will represent an important contribution in this regard.

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

We thank the staff for their well-written report and Mr. Rustomjee for the helpful preliminary statement. It is encouraging that Ethiopia is making very good progress under the PRFG-supported program. The authorities are to be commended for observing all performance criteria and structural benchmarks. The key macroeconomic indicators have shown very positive developments in 2000, with GDP growing by 7.5 percent. While the fiscal deficit and the external current account deficits have been lower than projected earlier, import cover of reserves also has improved slightly. A bumper food crop and increased food aid have led to a sharp reduction in inflation. The lower fiscal deficit as well as the lower external current account deficits partly reflect the impact of slower than anticipated project implementation. With the determined efforts by the authorities, we are hopeful that they would continue to make steady progress and we also encourage the authorities to effectively implement the reform measures to avoid any possibilities of policy slippages as suggested by the staff. We endorse the staff recommendation for the completion of this first review under the PRGF arrangement.

On fiscal policy, it is heartening that authorities have taken measures to offset the small shortfall in revenues, by reducing non-priority expenditures. We are also encouraged by the progress being made in the demobilization program and the consequent shifting of resources released to social development outlays. We welcome the actions taken by the authorities to make the large taxpayer unit fully operational. While we are concerned about the lack of progress until recently on the preparations for submission of the new VAT legislation to parliament, the completion of the survey on potential VAT payers also needs to be given due priority, for the new system to be made effective from early 2003.

Now that Temporary Security Zone has been established, we would appreciate the staff's comments on whether the delayed disbursements of external assistance which lead to a shortfall in the implementation of projects would fully recover during this year. We would also like to know whether the shortfall of project implementation was also related to any limitations of implementation capacity. We also note from the BOP data that there has been only a slight change in the total disbursements of official transfers and official long-term assistance in 2001/02 in favor of more grants. Though this is a favorable development in terms of impact on debt burden, the change is not very large.

We welcome the authorities plans for using market based instruments more effectively to absorb excess liquidity and the termination of wholesale foreign exchange market auctions to help improve the efficiency of the foreign exchange market.

We encourage authorities to take early action to strengthen the financial system and improve financial intermediation. In this regard, we note the initial steps for financial sector reforms as given in the box, and we believe that these would provide a good basis in their attempts to make further progress in the financial sector reform strategy. We fully endorse the staff recommendation to allow the entry of foreign banks which would help to increase competition and enhance financial sector efficiency. Given limitations of their supervisory capacity while we understand the authorities concern, a clear time frame may need to be set to liberalize the entry of foreign financial institutions. Such a measure could improve the prospects for foreign capital inflows as well.

We would also encourage authorities to be more ambitious in the proposed tariff reform program, by reducing the maximum rate and simplifying of the tariff structure.

We look forward to continued progress in the PRGF arrangement and wish the authorities all success in their economic policy endeavors.

Mr. Callaghan and Mr. Jang submitted the following statement:

We are grateful to the staff for a well-written paper.

Ethiopia should be commended for the progress it has made under the PRGF program under the steady progress of peace with Eritrea. The reference in the paper that the authorities' performance has been "satisfactory" perhaps does not do justice to the achievements that have been made. Ethiopia observed all the quantitative performance criteria, structural performance criteria, and benchmarks for end-June 2001 and has implemented all prior actions for the completion of the review. Fiscal performance was broadly consistent with fiscal revenue being smaller than expected, but it was more than offset by lower spending, and it is particularly encouraging that this occurred mostly in the defense area. On the basis of this good performance, we support the completion of the first review under the PRGF. We agree with the thrust of the staff paper and raise only a few points for emphasis.

Real GDP grew at 7.5 per cent in 2000/01, influenced by a bumper cereal crop. The report notes that non-agricultural activity appears to have recovered more slowly, but the reasons for this are not provided. However, non-agricultural activity is expected to pick up susbstantially in 2001/02. Is this turn-around primarily the result of a pick-up in infrastructure expansion and project implementation in 2001/02?

We welcome the authorities' commitment to implementing the measures needed to consolidate the fiscal condition:

As noted above, a particularly encouraging development has been the reduction in defense spending and an increase in poverty-targeted outlays. But defense spending is still around 5 percent of GDP. Further reductions in defense spending are necessary in order to give more room for increases in poverty-targeted outlays. This is crucial not only for the macroeconomic soundness of the country but also for the regional peace;

Continued efforts in accelerating the implementation of tax reforms and strengthening tax administration are vital. We welcome the recent establishment of a fully operational large taxpayer unit and encourage the authorities to streamline the management of the Federal Inland Revenue Authority and of the Ministry of Finance, especially in relation with the introduction of the VAT. Efficient implementation of a VAT requires substantial administrative capacity. The report notes that progress in this area had been slow until the time of the review discussions. The Fund is providing technical assistance, but we would be interested in hearing from staff if there are capacity limitations to be overcome with the implementation of the VAT.

Care will need to be taken with respect to further general wage increases. The hint of a pay rise may raise public expectations, placing considerable pressure on the authorities. The expected benefits from tax reform and improved tax administration are likely to materialize with a lag. We note that the authorities agreed with the staff that, in view of the uncertainty over tax revenue, they will implement additional measures if there is a revenue shortfall. We would be interested to hear if any specific contingency plans have been identified at this stage.

Regarding monetary policy, we welcome the authorities' efforts to improve monetary management by adopting a rediscount window, and to improve the functioning of financial markets by curbing the commercial banks' excess liquidity. We share the staff's view that the investment and growth objectives envisaged in the I-PRSP depend on effectiveness and competitiveness the financial sector. In this context, it is encouraging to see that the authorities reviewed the medium–term strategy of financial sector reform with the joint Fund/World technical assistance mission as presented in Box 2.

We appreciate the authorities' caution over the entry of foreign banks and the reform of the state-owned CBE, the largest commercial bank in the country. They are correct that improving the prudential supervisory capacity of the NBE is an important adjunct to increasing competitive pressures within the financial sector. Nevertheless, a well-functioning financial market is essential to the growth prospects for the economy. The entry of competition and expertise through the entry of foreign banks in many respects can be a spur to reform as well as providing access to modern technology and skills. As such, we would suggest that the authorities' reconsider their policy in this area and, in particular, not contemplate delaying the opening of the banking market for several years.

The structural conditionality of the original and the revised program appears to have been well-focused. We welcome the authorities' continuing efforts to implement key structural reforms, supported by an Economic Rehabilitation Support Credit, focused on public sector management, public expenditure management, private sector development, and export competitiveness. Particularly encouraging is the authorities' determination to ensure good governance and to prevent corruption through passing a relevant bill. Adherence to these reforms is vital.

While we take note that progress is being made in the preparation of a full PRSP, it will be important to ensure the full participation of civil society and international development partners. We also agree with staff about the importance of further improving the compilation of macroeconomic statistics on a timely basis, in line with the Fund's recommendations.

In conclusion, the progress Ethiopia has made under the PRGF is encouraging and we wish the authorities every success for the future.

Ms. Phang made the following statement:

I join Mr. Callaghan and Mr. Kelkar in commending the Ethiopian authorities for the progress made during the first annual arrangement under the PRGF-supported program. With the restoration of peace with Eritrea, Ethiopia has met all quantitative and structural performance criteria and benchmarks for end-2001, and implemented all prior actions. Overall performance has been broadly in line with the program, as better than projected performances in certain areas, such as the required reduction in public spending, have compensated for shortfalls in other areas, like revenues. We agree with Mr. Callaghan's view that the staff understates Ethiopia's achievements when it refers to them as merely satisfactory, especially in view of the worse than expected global environment and the rapid deterioration in commodity prices, including coffee, which is one of Ethiopia's major export items. We fully support the staff's recommendation for the completion of this first review under the PRGF arrangement.

We concur with most of the views expressed in Mr. Callaghan's preliminary statement, except for the need to bring forward the entry of foreign banks into the banking system. While we feel that the expertise and technology provided by foreign banks can enhance efficiency and competitiveness, and spur reform, a correct timing of their entry will be the critical element to guarantee that the desired objectives can be achieved. In this respect, we feel that the authorities have good grounds for maintaining caution. It is precisely because a well functioning and efficient financial market is essential for growth that the authorities may need some breathing space to enable them to introduce the necessary reforms to strengthen domestic banks before opening the doors to foreign banks. The prospective entry of foreign banks will provide the necessary incentives for reform, and the benefits from increased competition and expertise associated with the eventual entry of foreign banks will spread throughout the whole banking system if domestic banks have been allowed the time needed to strengthen their positions. If the domestic banks are not strong enough, opening the system to foreign banks would be analogous to throwing a lightweight against a heavyweight, and the lightweight can be knocked out in the very early rounds, if not the first round itself.

In this connection, we were surprised by the staff's view that the Commercial Bank of Ethiopia (CBE) should have been broken up by the time of the second review. This seems to run counter to the common trend in all countries to move toward mergers and acquisitions. Ethiopia is not an excessively large country and, if the CBE is broken up, it might not be able to take advantage of economies of scale. The CBE does not enjoy the advantages of advanced technology and large capital which would be provided by parent banks in the case of subsidiaries of foreign banks. We acknowledge the advantages of opening up the banking market, but this has to be carefully managed to ensure that the country can benefit from it. We should also bear in mind that there are other ways of achieving the same objective. We support the approach adopted by the Ethiopian authorities to strengthen domestic banks through the introduction of foreign management. In fact, based on experiences in other countries, they could even go a step further and allow a few small banks to go into joint ventures with foreign banks, while concentrating their efforts on strengthening the competitiveness and efficiency of domestic banks—including the CBE—with the aim of bringing them up to international standards. The question of opening up the banking sector can be considered at a later stage, once domestic banks and the country in general have ripped the benefits from joint ventures with foreign banks.

With these remarks, we wish the authorities continued success in their endeavors, as we realize that they need encouragement in these challenging times.

Mr. Weisman made the following statement:

Ethiopia has performed well during the first several months of this program, and we look forward to continued progress. Based on this review, coupled with reviews under the previous two Fund programs, we have learned that when the authorities are able to devote their primary focus to economic policies, we can expect to see significant progress in achieving program targets.

As we examine country programs in general, we look for a design that is neither over-ambitious nor under-ambitious; that balances ownership and commitment with the need to implement crucial macroeconomic and structural reforms; and that balances capacity constraints against the objective of making the most effective use of scarce IMF resources. In the case of Ethiopia, we think the authorities can do more without jeopardizing their good performance. Thus, in the wake of their success, we hope to see a more ambitious set of structural performance criteria in the next annual arrangement. We would specifically like to see the authorities focus more aggressively on the financial sector, the National Bank, and fiscal management.

As the staff duly notes, improvements in the financial sector in Ethiopia are vital to the reform program, and Box 2 is helpful in identifying a set of sound measures for short-term reform in this sector. We feel strongly, however, that privatization of the Commercial Bank of Ethiopia and the further opening of the banking and insurance sectors to private participation are pivotal reforms that should also be considered in the near future. These two crucial steps would improve the efficiency of the financial sector by bringing in new management skills and technology, increasing transparency, and raising the capital base, while fostering a much-needed increase in private sector access to credit and attracting valuable foreign investment. With regard to CBE in particular, a management contract was recently signed, and we would ask the staff to provide more details, including which firm was hired and the staff's impression of the bidding process. We also would ask the staff to tell us what the percentage of non-performing loans is for CBE.

We agree with the staff on the centrality of the independence and regulatory function of the National Bank of Ethiopia, and we support the improvements suggested in Box 2. In the near term, we urge a smooth transition from the foreign exchange auction arrangement to a more efficient interbank system. In an environment where monetary policy tools are limited and new, we also encourage the Fund to provide technical assistance to NBE to promote the effective use of these tools. Further to this point, paragraph 26 states that a stage-two safe guard is necessary, and we would ask the staff to provide more information.

On the fiscal side, the reduction in military expenditures and increase in social sector spending are encouraging. However, we note that the regional average for military spending is about 3 percent of GDP, and we join others in urging the authorities to further reduce its military expenditure below the program target. Concerning another expenditure issue, paragraph 30 and the Statistical Issues Appendix mention off-budget and extra-budgetary funds, and we would ask the staff to explain further what these accounts are, where the money comes from, and whether spending on defense is affected. Improvements in revenue collection are also important, and we welcome the improvements made under the tax reform program. We urge the government to bolster its efforts regarding VAT legislation and to move faster to lower the maximum import tariff rate and the number of bands.

We appreciate the inclusion of Box 4 on HIV/AIDS and urge the staff to provide more analysis of the macroeconomic impact of this epidemic on Ethiopia and other affected countries. The effect of HIV/AIDS in Ethiopia and several other nations is going to be significant and must be closely monitored. We look forward to examining the results of the World Bank's pilot program in this area.

Finally, the issue of land tenure and title is critical in an agriculturally driven county like Ethiopia, both in terms of output and for mobilizing domestic and foreign capital. Yet this issue appears not to have been taken up in the programs with either the Fund or World Bank. We urge the staff and the authorities to study and address this issue, as it will be one of the keys to unlocking the vast potential of Ethiopia's economy.

Mr. Kwakye made the following statement:

Since we agree with the thrust of the staff appraisal, we will only make a few comments for emphasis.

Ethiopia's implementation of the PRGF is broadly on track, and performance has been satisfactory. All performance criteria and benchmarks for March 2001 were met. Real GDP growth for 2000/01 is expected to be satisfactory, inflation is to turn negative, and the external current account deficit is projected to be lower than programmed. Progress has also been made on key structural reforms. There is a strong commitment to fiscal reforms and fiscal consolidation. Major tax reforms have been implemented, including an increase in the sales tax and removal of the import duty surcharge. We encourage timely implementation of further tax reforms, including the VAT.

On the expenditure side, we welcome the reallocation of spending from defense to the social sector, and we hope that this trend will continue in the future. However, capital spending and spending on demobilization and reconstruction are hard to curtail. We welcome the projected pick-up in capital expenditure in 2001/02, and the expected increase in external assistance disbursements after significant delays in such disbursements in the past. The intentions to control the wage bill and cut defense outlays further are also welcome.

The monetary policy stance has been cautious, given the targets of low inflation and an adequate level of international reserves. The plan to adopt indirect instruments and market-determined interest and exchange rates is welcome. Financial intermediation, however, remains limited, with a highly concentrated banking sector and inadequate credit to the private sector. The financial sector reform program should help rectify these weaknesses. Bank supervision should also be strengthened to ensure a sound and efficient banking system, and the safeguards assessment of the National Bank of Ethiopia (NBE) should help improve its operating and reporting procedures.

Structural reform is important to ensure a more diversified and efficient economy. We were pleased to note the progress made in privatization, with the additional sale of seven public entities, as well as the progress made in judicial and civil service reform. The other important areas of reform receiving due attention include public sector management, private sector development, and strengthening of the regulatory and legal framework. Improving governance is also a priority, and the establishment of the Federal Ethics and Anti-Corruption Commission is a step in the right direction. The preparation of the full PRSP is progressing, and the targeted completion date of March 2002 seems attainable. More work remains to be done, including further analysis of poverty incidents, elaboration of an HIV/AIDS strategy, and a further broadening of the consultative process to build consensus and enhance program ownership.

Ethiopia will continue to need large concessional assistance in the coming years, given its large reconstruction and poverty reduction needs. The authorities have demonstrated a strong commitment to program implementation, and it is reassuring that they intend to maintain this commitment. With these remarks, we support the completion of the first review under the PRGF.

Ms. Manno made the following statement:

We are very pleased to discuss the first review of the PRGF arrangement since it will give more solid ground to the forthcoming discussion of the completion point under HIPC assistance to Ethiopia. This discussion is also particularly interesting coming soon after the Board meeting on conditionality and cooperation with the World Bank. Box 3 in the staff paper provides an interesting assessment on the importance of structural conditionality for the achievement of program objectives and describes Ethiopia as another good example of functioning cooperation between the Fund and the World Bank in setting a comprehensive framework.

Macroeconomic Developments

We commend the authorities for having met all quantitative and structural performance criteria and benchmarks. The economic outlook for 2001-02 is promising. With the resumption of growth, partly generated by restoration of external lending and gradual reduction of military spending after the end of the conflict with Eritrea, as well as improved agricultural output in 2000, the number of people reliant on emergency assistance has been reduced. As food supply returns to a more normal level, consumer price inflation is expected to rise to an average of 5 per cent in 2001/02. We believe that the central bank should not overreact to such an occurrence.

We are concerned that the present trend of reduction of military spending may be jeopardized by the uncertain security outlook. Does staff have updated information on the situation there.

We concur with the staff appraisal that authorities should continue to pursue fiscal consolidation and accelerate the pace of implementation of the tax reform. At the time of last Board discussion we expressed concern on possible risk of expenditure overshooting, we are pleased to see that authorities were successful in containing and prioritizing expenditures. We urge them to purse this course of action, even in times of resumption in the disbursement of external assistance.

Financial sector reform is proceeding, although much remains to be done especially in terms of liberalizing the banking sector. We understand the reluctance of the authorities to increase competition at least until domestic banks have been strengthened and the supervisory capacity of the NBE improved. They should be aware, however, that delaying the process will hamper achievement of investment and growth objectives and be detrimental to the potential for private sector development.

The creation of an environment conducive to private sector development is very important for Ethiopia. In this context, we are concerned that old disputes concerning expropriation issues have not been solved yet, we would appreciate to hear from staff whether there is any progress on this issue.

Challenges Ahead

Ethiopia is still confronted with many important challenges. The country is very dependent from external assistance. Long-term debt sustainability is contingent to the availability of grant resources. It is therefore important that progress be made in areas which are crucial to donors: The transparency of public expenditures and the mechanisms to monitor them are of fundamental importance in Ethiopia. Possible improvements could be envisaged in the frequency of the Public Expenditure Reviews, in the depth of their analysis, as well as in the procedures to ensure and monitor compliance with the recommendations.

Two issues are of particular relevance in the PER context: (i) An exceptional effort to monitor military expenditures, which is particularly warranted in a country recently engaged in a major conflict; and (ii) monitor resources devoted to the Central Statistic Authority. Statistical weaknesses in fact hamper—among other things—the assessment of the effectiveness of government efforts to reduce poverty.

Ethiopia has the third largest population in the world living with HIV/AIDS. Although the exact economic impact is difficult to quantify, there is no doubt that the problem should be addressed vigorously.

The international community is ready to help through debt relief, financial and technical assistance as well as broader support for the reform process. The (New) Partnership for Africa is a tangible sign of such support.

Initiatives that go beyond debt relief will now be available for those countries who seriously engage in the needed reforms through a participatory approach, which will enhance ownership and thus the sustainability of the program. A special effort is required by the Ethiopian authorities to be able to take advantages of these new initiatives. Steps have been taken and we are pleased to note the commitment to address delicate issues like governance, we also recognize that a complex administrative system could make a participatory approach difficult. However, we urge the authorities not to lose momentum and forcefully address this issue in the preparation of the full PRSP, together with other outstanding issues, such as food security policy, gender consideration, diversification of the economy, judiciary and civil service reform.

Political stability is essential to achieve the program objectives. Still the situation in Ethiopia is fragile. This calls for an increased monitoring of the authorities' commitment to program objectives.

Mr. Bauche made the following statement:

I join other Directors in commending the authorities for their strong performance under the program. Since I concur with the thrust of the staff recommendations, let me just comment on a few areas.

Positive developments on the fiscal front are welcome, and I encourage the authorities to maintain their efforts, especially on revenue collection, which was slightly below target for 2000/01. Strengthening administrative capacity will be important in order to reach the 10 percent of GDP target for capital expenditures in 2002 under the program. I also join Mr. Callaghan and others in urging the authorities not to delay the implementation of reforms in the financial sector, including restructuring existing banks and improvements in supervisory capacity.

I appreciate the detailed information provided on financial sector reform in Box 2, as well as the indications in the report that this reform could be established as a completion point trigger. The establishment of a tentative agenda for the privatization or breakup of the CBE by the time of the next review would also be helpful. I fully concur with the staff's recommendations regarding the elaboration of a full PRSP, including the need for an in-depth analysis of growth and its linkage to poverty, a fully-fledged HIV/AIDS strategy, and fiscal reporting on social expenditures.

Finally, I appreciate indications in Box 3 on structural conditionality coverage by the Fund and the Bank. However, I feel it would have been useful to include a more detailed review of progress in a number of structural areas which are important for the success of the program. Those include public expenditure management, judiciary and civil service reform, and decentralization—these last two reforms have also been identified as priority objectives in the I-PRSP.

I wish the authorities well.

Mr. Alosaimi made the following statement:

I broadly agree with the staff appraisal and will only emphasize a few points.

I am encouraged by Ethiopia's perseverance with adjustment and reform in difficult conditions. I welcome the program's continued priority for fiscal consolidation and on reorientation of budgetary resources toward poverty alleviation outlays. The emphasis on acceleration of tax reforms is also appropriate. Regarding the introduction of VAT in 2003, I agree with the priority set out in the report. Here, Fund continued technical assistance in this area cannot be overemphasized. In this regard, like others strengthening the federal and regional administrative capacity to improve expenditure monitoring is also critical.

The authorities should maintain the momentum for implementing the comprehensive strategy to both adopt an active monetary policy and restructure the financial system. A priority here is to complete the pending reforms of the Commercial Bank of Ethiopia. Indeed, increased competition and strengthening supervision in the banking system are critical for greater efficiency of the intermediation process. The envisaged reform strategy is indeed extensive and will require a strong effort to implement. As Box 2 shows, the first phase of the strategy comprises a number of demanding tasks that will challenge the country's limited administrative capacity. Here, close staff monitoring of the progress with appropriate technical assistance is important.

On the broader structural reforms, the authorities' focus on strengthening the legal and regulatory framework is appropriate. I am also encouraged by the ongoing efforts to improve public sector management. The authorities' intention to complete the privatization program over the medium term also bodes well for growth prospects.

I welcome the progress toward a full PRSP. I share staff's stress on the need for an-in-depth analysis of growth and its links to poverty. In this connection, the recently established interministerial steering committee and a secretariat for the preparation of the PRSP is a step in the right direction.

With these remarks, I support the completion of the first review under the PRGF and wish the authorities further success.

Mr. Liu Fushou made the following statement:

At the outset, we wish to thank staff for a detailed and insightful report and Mr. Rustomjee for his helpful preliminary statement.

Macroeconomic developments in Ethiopia during the first nine months of 2000/01 were favorable. All performance criteria and benchmarks under the program were observed. Real GDP growth and the external current account deficit for 2000/01 are in line with program projections, while inflation turned negative, reflecting bumper cereal crops and food aid. The overall fiscal deficit is estimated to be lower than programmed and social spending was in line with projections. Credit must go to the Ethiopian authorities, whose firm commitment and determination to the program are essential to the on-track implementation and success of the program and to the medium-term economic outlook. We are encouraged to learn that, building on the satisfactory results achieved so far, the authorities are determined to continue with the steadfast implementation of the program in order to achieve their objectives for 2000/01 and 2001/02. In light of the satisfactory implementation of the program and the authorities' commitment to its success, we fully support the proposed decision. Since we are in broad agreement with the staff appraisal, we will make just a few comments for emphasis.

First, in the fiscal area, we are pleased to note that the authorities have embarked on comprehensive tax policy reforms and an overhaul of tax administration. A substantial tightening of fiscal policy is the core to the successful implementation of the program. Therefore, we encourage the authorities to continue with their cautious spending policy. We welcome the recent establishment of a fully operational large taxpayer unit and submission of value-added-tax (VAT) legislation to parliament by October1, 2001. On the expenditure side, we are encouraged to observe that the government has followed cautious expenditure management and will continue its efforts to improve substantially its control, tracking and reporting mechanisms of expenditures at both the federal and regional level. We welcome the increase in poverty-related spending.

Second, in the monetary and exchange areas, we are of the same view that monetary policy should remain geared toward containing inflation and achieving the international reserve target. To achieve this, the importance of granting full independence to the central bank cannot be overemphasized. The revision of the existing Banking Act to increase the autonomy of the NBE will be an important step in this direction. It is also welcome that the authorities have started to improve monetary management by using indirect policy instruments, and to improve the functioning of financial markets by sterilizing excess reserves of commercial banks and removing distortions from the foreign exchange markets. On the financial sector, while we agree with staff that achieving sustainable economic growth requires an expansion and modernization of financial services and a more efficient system of financial intermediation, and that the strengthening of the financial sector will require more effective and equitable competition, like Ms. Phang we have reservations about the recommendation to allow foreign banks entry into the financial sector and the privatization of the Commercial Bank of Ethiopia

(CBE). It seems understandable that the authorities will not allow foreign banks entry into the financial sector until domestic banks have been strengthened and the supervisory capacity of the NBE improved.

Third, on the structural front, it is encouraging that much progress has been made, with World Bank assistance, in identifying the main constraints on private sector development, especially in the regulatory areas, and the measures needed to redress these constraints. Similar progress has been made in other key areas, including capacity building, and judicial and civil service reforms. We would encourage the authorities to continue with their structural reform efforts in the areas as detailed in paragraph 27 so that a better environment for promoting private sector investment and economic growth is created.

To conclude, we support the staff proposal and wish the authorities further success in their future endeavors.

Mr. Pickford made the following statement:

I would like to compliment the government's robust performance under the PRGF-supported program—all performance criteria and benchmarks under the program have been observed—despite the tense political situation.

The fiscal deficit and defense outlays are also lower than envisaged in the program. I broadly endorse the staff's recommendations for further fiscal consolidation, reorientation of budgetary resources from defense toward poverty alleviation outlays, and the implementation of tax reforms, including the introduction of a VAT. Like other speakers, I also emphasize the need for further reductions in military spending as a share of GDP.

I join the staff in stressing the importance for economic growth of making rapid progress in improving the efficiency of the financial system, particularly by resolving the situation of the CBE.

I would also like to welcome the government's commitments to introduce tax reform measures to strengthen revenue performance. The authorities should ensure that new taxation structures will be favorable for the poor. In this regard, I welcome the government's intention to cover major macroeconomic and structural measures in the PRSP. In particular, I welcome the proposals to strengthen the welfare monitoring system and to analyze the general impact of public policy on the poor, as well as the introduction of a system to track HIPC expenditures.

Finally, I welcome the establishment some months ago of the PRSP steering committee, and the commitment of the government to preparing a full

PRSP with participation of local civil society and international donors. However, progress in preparing the PRSP has been slow, and I would like to ask whether a consultation and participation action plan—including a detailed timetable for the specific steps to be taken—is already in place. This is an important issue, and I would hope to see evidence of progress before we reach the HIPC decision point.

With these comments, I agree with the proposed decision on the first review under the three-year PRGF.

Mr. Kudiwu made the following statement:

We thank staff for their excellent paper, and Mr. Rustomjee for his helpful preliminary statement on recent developments in Ethiopia. As pointed out in the staff report, the authorities are to be commended for the overall achievements in the macroeconomic and structural policy areas under the 2000/01 program. I am pleased to note that progress toward peace with Eritrea has contributed favorably to these positive developments. We are also encouraged by the explanations provided by Mr. Rustomjee indicating that prospects for a successful implementation of the remaining measures under the program are good. In light of these developments, we support the completion of the first review under the PRGF. As we generally agree with the thrust of the staff paper, we will only raise a few points for emphasis.

In the fiscal area, there is a need to intensify efforts toward further fiscal consolidation, as this will be critical for the successful implementation of the current program. Every effort should be made to forcefully reduce defense spending, given the progress made toward achieving peace with Eritrea. We also welcome the authorities' intention to increase poverty-targeted outlays and implement the envisaged tax reform measures. On the revenue side, the authorities are encouraged to forcefully implement tax administration reform and the measures adopted since January 2001. The introduction of a VAT should be carefully prepared. Staff comments on the status of these preparations would be welcome. On the expenditure side, the situation seems to show important weaknesses, given the still fragile environment facing the authorities. Therefore, we encourage the authorities to maintain fiscal discipline, and we look forward to the completion of the public expenditure review by end-2001.

In the monetary area, the orientation of monetary policy toward containing inflation and achieving the international reserve targets will remain essential. However, the high level of nonperforming loans—both from state-owned and private banks—indicated in Box 2 of the staff report is worrisome and would need to be addressed without delays. Regarding financial sector reforms, we support the improvements proposed in Box 2.

In the structural area, the authorities are to be commended for implementing, in consultation with the World Bank, key structural and public sector management reforms, including civil service reform, public expenditure policy, private sector development, and export competitiveness. The authorities' intention to tackle governance and corruption issues is encouraging. In this regard, the establishment of the Federal Ethics and Anti-Corruption Commission in May 2001 is a move in the right direction. However, we would like to sound a note of caution regarding the ambitious nature of the privatization program—which aims to bring 114 public entities to the point of sale between 2001 and 2003—as we do not believe that this target will be feasible. Rather than covering such a large number of enterprises, we think the emphasis should be placed on the public entities with a greater impact on the macroeconomic framework. Comments from the staff on the degree of realism of the authorities proposals would be welcome.

Finally, we are reassured by the information provided by Mr. Rustomjee concerning the steps to be taken in preparing the full PRSP, with full participation of civil society and development partners. We look forward to seeing further debt relief granted to Ethiopia. We also want to emphasize the need for technical assistance to help improve the country's weak capacity, as this will be critical to ensure a successful implementation of the program.

With these remarks, we wish the authorities every success.

The staff representative from the African Department (Mr. Tahari), in response to Mr. Kelkar's question regarding the prospects for a recovery in disbursements of external assistance after the establishment of the temporary security zone, confirmed that the authorities expected external assistance to be forthcoming during the current fiscal year. While the limited capacity that had partly contributed to delays in disbursements for 2001/01 still needed to be resolved, the staff viewed the levels of external assistance envisaged in the 2001/02 public budget as being realistic. While, as some Directors had observed, the security situation was still tense, the authorities remained determined to move ahead with the consolidation of the peace process with Eritrea.

On Mr. Callaghan's question related to the rate of growth of the nonagricultural sector, while the main reason for such weak growth had been the slow pace of project implementation, sluggish private sector activity in a context of continued weak confidence had contributed as well, the staff representative pointed out. The staff expected project implementation and private sector activity to gather momentum in 2001/02.

Capacity limitations had been the main cause for the postponement of the introduction of a VAT until January 2003, the staff representative confirmed. The recent establishment of a large taxpayer unit, and the intention to introduce the VAT legislation (a performance criterion in the program) with technical assistance from the Fiscal Affairs Department would pave the way for the implementation of the VAT in early 2003. More generally, increases in excise taxes—mainly on petroleum products—should be used as contingency measures in the event of a shortfall in fiscal revenue.

Regarding Mr. Weisman's question on the management contract recently signed by the CBE, the staff representative informed that the State Bank of India had been the only bidder for the contract. The impression among the banking community appeared to be that the lack of bidders could have been related to the inadequate timing of the bidding process, as bidders would have probably needed a more extended period to prepare their proposals. Nevertheless, the Indian bank had previous experience in Africa, having engaged in similar contracts in Ghana and Nigeria. On a related issue, the percentage of nonperforming loans in the CBE's assets—excluding claims on Eritrea—had been estimated to be 19.8 percent.

A staff mission had discussed the outcome of the safeguards assessment with the central bank in late June, the staff representative noted. The staff report, which had already been submitted to the authorities for their consideration, would be finalized once the staff had received the authorities' comments. The staff would report the findings and recommendations arising from the mission to the Board once the assessment has been completed. As far as the use of the extrabudgetary funds, it was noted that the sugar fund had been discontinued. Of the remaining two funds, the oil stabilization fund was mainly being used to finance existing subsidies on kerosene products with revenue from taxes on non-kerosene petroleum products. The operations of this fund appeared to be transparent. Resources in the privatization fund were being directly transferred to the public budget. Therefore, available evidence suggested that these funds were not currently being used to finance defense outlays.

On Ms. Manno's question regarding the resolution of expropriation issues, the staff representative explained that the Multilateral Investment Guarantee Agency (MIGA) was playing an intermediary role in the negotiations, and it was hoped that the situation could be resolved soon.

The authorities, including the Prime Minister and the Minister of Finance, were determined to continue reducing military expenditure beyond the birr 3.3 billion target agreed with the staff, the staff representative noted. While several Directors still considered the current military expenditure—equivalent to 5 percent of GDP—to be excessive, the authorities' commitment to reducing defense outlays despite the tense security situation in the country was encouraging.

On the PRSP, the staff representative agreed with Mr. Pickford that progress had been slow. Nevertheless, the staff's perception was that the development of the PRSP had been accelerated recently with the establishment of a ministerial committee and a Secretariat, as well as with the finalization of the specific action plan. While the staff was willing to encourage the authorities to meet their early 2002 target for the preparation of a full PRSP, it was also important to guarantee the good quality of the PRSP. The authorities intended to hold consultations with the local leadership first, and to start consulting donors after that. Perhaps the completion of the PRSP could be delayed by a few months. The staff would continue to monitor the situation in the context of the upcoming September 2001 mission, during which the HIPC decision point document would be discussed with the authorities. The staff would subsequently update the Board on developments.

Regarding Mr. Bauche's point on public expenditure and civil service reform, the Bank was carrying out a public expenditure review together with other donors, the staff representative remarked. The staff would report on the progress made in this front during the next Board meeting on Ethiopia.

On privatization, the number of 114 companies to be privatized was misleading, given that this did not refer to the total number of enterprises, but to the number of entities that made up the public enterprises—some of these were made up of up to 10 or 15 smaller entities, the staff representative noted.

Ms. Phang reiterated her question on the staff's recommendation to open up the banking system to foreign banks and on the proposed breakup of the CBE at a time when the international trend was toward increased consolidation through mergers and acquisitions. Perhaps the staff could provide further detail on the size of the customer base so that Directors could assess the adequacy of the proposed option of breaking up the bank into smaller entities and the foregone economies of sale that would be associated with the breakup.

The staff representative from the African Department (Mr. Tahari) responded that the dominance of the CBE in the banking system was the main issue. The bank had controlled 100 percent of deposits and loans a few years earlier. Since then, five or six private banks had emerged as the authorities had started opening the system. However, the CBE was still the dominant bank, accumulating 83 percent of deposits and more than two-thirds of loans. During the discussions with the authorities, there had been no disagreement on the need to restructure the financial sector. The staff's views had been provided in an extensive staff report on financial sector reform issued in 1998. The authorities were convinced that a sound system—based on an environment that provided the necessary incentives to increase banks' competitiveness—would be critical to achieve growth. There were different options to achieve these objectives, including breaking up the CBE—which would be appropriate taking into account that the fundamental issue in the banking system was the dominance of the CBE—privatizing the CBE, and allowing the entry of foreign banks to guarantee an acceptable degree of competition and the determination of interest rates and the exchange rate according to market mechanisms. The authorities' preferences when the program had been presented to the Board in March 2001 had leaned toward delaying the entry of foreign banks by at least two or three years to allow for the restructuring of the CBE, the reform of the banking sector, and the enhancement of the independence of the NBE.

Ms. Phang questioned the adequacy of the staff's advice to break up the CBE to reduce its dominance in the banking sector. While the existence of a competitive and efficient financial system would be crucial for the achievement of sustainable growth, and it could eventually require the breakup of the bank, the fact that the bank's activities currently accounted for approximately 85 percent of the banking system—down from 100 percent some years earlier—did not necessarily mean that breaking up the bank would be the best course of action at the country's current stage of development.

The Acting Chairman (Mr. Sugisaki) clarified that the staff had not implied that this would be the only available option.

Mr. Zakharchenkov asked the staff for some clarification on the reasons for the delay in the disbursement of IDA credit.

The staff representative from the African Department (Mr. Tahari) indicated that the staff's understanding—on the basis of the information received from the Bank—was that the delays had been of a technical nature.

Mr. Chelsky made the following statement:

> We are encouraged by the progress made in implementing the program. We think it rightly focuses on the three important objectives of consolidating peace with Eritrea, reallocating resources from the military to development-related expenditures, and promoting good governance. These objectives provide the essential foundations for the economy to grow and develop. As Mr. Rustomjee says, if the current trend continues, prospects for the Board's revalidation of the HIPC Initiative decision point in the fall of 2001 will continue to improve.
>
> With respect to the entry of foreign banks into the domestic market, I largely agree with the staff's and Messrs. Callaghan's and Jang's comments urging the authorities to reconsider their policy in this area, and to refrain from delaying the opening of the banking market for several years. Having said that, the possibility of a partial and gradual opening, rather than a complete and immediate opening, of the banking sector could also be considered. In this regard, receiving a medium-term timetable stating the authorities' intentions to gradually open the market in order to allow the domestic financial entities time to adjust to international competition could provide and acceptable intermediate solution to this issue. On the other hand, merely arguing that this is not the right time without providing any specific indications of a tentative timetable for the liberalization of the sector would fail to provide domestic banks with the encouragement needed to achieve the objective of developing a competitive domestic sector.
>
> I wonder if the staff could comment on the findings reached in their assessment of the progress made in setting up a welfare system with adequate monitoring mechanisms, as we consider this to be an important aspect of reform that needs to be encouraged.
>
> We would also like to associate ourselves with the comments made by Mr. Bauche on the discussion in the staff report on structural reform

conditionality, and also with the comments made by Mr. Kudiwu on the privatization strategy. In particular, we would like to stress the general principle of the need to focus on the most significant entities rather than on an excessively large number of entities.

Mr. Sipko made the following statement:

We would like to thank the staff for its paper and Mr. Rustomjee for his informative statement.

The performance of the Ethiopian economy has generally conformed to the PRGF program. All of the quantitative criteria and structural benchmarks for March 2001 were observed. Serious challenges still confront the Ethiopian authorities. These include decreasing defense spending, shrinking the current account deficit, improving monetary management, strengthening banking supervision, and continuing to liberalize tariffs. Based on Ethiopia's performance so far, we support the completion of the first review under PRGF. Let me now turn to some specifics.

We welcome the steps taken so far toward fiscal consolidation, but note that much still remains to be done, especially improving tax administration and making the large-taxpayer unit fully operational. We encourage the authorities to prepare the VAT legislation and present it to parliament in timely fashion. And though defense-related spending has decreased further than programmed, we urge the authorities to keep reducing these unproductive expenditures while increasing their spending on poverty reduction. In this connection, could the staff indicate what will likely be the relative levels of defense spending and poverty-related spending in the medium term?

Financial sector reform will be crucial for achieving sustainable growth while continuing to reduce poverty. We welcome the technical assistance from the Fund and the World Bank. Making the financial sector more competitive will require the cleaning up of non-performing loans in both state-owned and private banks. In Box 3, the staff gives a detailed picture of the financial sector reform. Could the staff tell us more about the resolution of non-performing loans and its potential effect on the budget? The authorities have also been working on a comprehensive program aimed at improving their medium-term fiscal strategy. The financial sector reform will not be assess until the second program review in December, we would welcome some comment from the staff about certain criteria that were to be met by end-June.

Based on recent developments in the trade area, the projections of the medium-term balance of payments have been updated to take account of the most recent WEO projections and the latest data on coffee and food relief. These projections indicate that the current account deficit will increase. The financing gap will be met with World Bank financial assistance under the special program for reconstruction and demobilization. The staff notes that Ethiopia will continue to need highly concessional external assistance in the medium term. Some comment from the staff on Ethiopia's medium-term financing needs would be welcome.

We are pleased that progress has been made since the Paris Club meeting of April 15, 2001 toward finalizing the bilateral agreements with Ethiopia, which has paid off some of its bilateral debt to Russia in early April 2001 and was slated to pay the remainder in early July. Does the staff have any information about whether this obligation has been met? We agree with the staff that Ethiopia should seek to reschedule its debt to non-Paris Club creditors on terms at least comparable to Paris-club terms.

The Ethiopian authorities have made significant progress under the PRGF-supported program. We to wish the authorities great success in their further endeavors.

Mr. Zakharchenkov made the following statement:

I broadly share the staff's analysis of economic developments in Ethiopia and corresponding policy recommendations. Therefore, I will be brief and focus my remarks on a couple of issues for emphasis.

The main risk to the current program stems from the tense political situation in the country which is well described in paragraph 13 of the report. Against this very difficult political background the authorities are certainly to be commended for keeping the program on-track and even attaining better results in certain areas than originally envisaged. The observance of all performance criteria and benchmarks for the first review is very reassuring. Here, I agree with Ms. Phang that characterization of the progress under the program as satisfactory is probably an understatement.

With respect to the CBE restructuring, we noted that the authorities' hesitation to proceed with this issue stems from their political commitment to postpone privatization and/or break up of the CBE until adequate regulatory framework and supervision capacity of the NBE are in place. Therefore, we can go along with the authorities' position at this stage. However, this transitional period should not last any longer than it is really necessary. Also, let me say that the reform of the CBE will almost inevitably be a trigger for reaching the floating completion point under the HIPC. In this connection, I have two observations. First, I call upon the staff to make this trigger very specific and monitorable. Second, whatever the trigger will be (here I do not pretend to forecast the outcome of discussion with the authorities), its completion should provide a lasting solution to the CBE's solvency problems.

I also wish to confirm that the remainder of the late payment on the consolidated debt to Russia has been paid last month as scheduled.

With these remarks we support the completion of the review and wish the Ethiopian authorities well.

Mr. Azoulay made the following statement:

We commend the Ethiopian authorities for their success in implementing policies consistent with the PRGF-supported program. The steady progress made toward achieving peace is also notable. We share the thrust of the staff appraisal. In particular, we concur with the four policy recommendations mentioned on page 4. We also support the proposed decision. This chair would like to make the following specific remarks.

The decline in defense expenditure is encouraging, although we feel that the figures presented exclude off-budget items. We support further efforts by the authorities in this direction. While the increase in poverty-targeted expenditure is also encouraging, a more detailed breakdown of the composition of these expenditures would be welcome. We wonder how poverty-targeted expenditures are defined. In particular, we consider the extent to which investments in roads and agriculture could be considered poverty-targeted expenditures debatable. Could the staff confirm if the largest share in the authorities' classification of poverty-targeted expenditures corresponds to investments in roads financed with external funds?

Further progress in opening up the banking sector to foreign investment is needed, as this would help improve the efficiency of the banking sector by enhancing competition and allowing inflows of foreign capital and expertise. We recommend that the authorities continue to gradually implement capital account liberalization in a way that is consistent with continued macroeconomic and financial stability. This will require the continuation of sound economic policies.

Regarding the triggers for the HIPC Initiative completion point, we believe that it would be advisable to slightly increase the number of triggers and to improve the definition of the triggers that have already been suggested before presenting them for Board consideration. In particular, the discussions on social policies in the staff report for this Board discussion should provide a thorough analysis of the impact of these policies on the medium-term outlook.

The staff representative from the African Department (Mr. Tahari), in response to Mr. Chelsky's question on the welfare system, observed that, while some progress had already been made in this area, further analytical work would be needed to produce a set of indicators to assess the incidence of various policies on poverty. Such indicators could be based mainly on the results obtained from the household and expenditure survey. The World Bank was working closely with the authorities in this area.

Regarding the requests for additional details on the composition of social spending in the context of the HIPC Initiative, the staff representative said that the information would be provided in the decision point document to be prepared jointly by the Bank and the Fund in early September 2001. The staff report under consideration in the current discussion provided a comparison of aggregate defense and social spending which clearly showed that defense spending was declining—even if it was still high—and that spending on social policies had significantly increased in the last two years. The construction of roads was extremely important in Ethiopia and the inclusion of these investments as poverty reduction-related expenditures was probably justified. During its most recent mission to the country, the staff had been able to assess the existence of at least an indirect impact of such investments on poverty reduction.

Mr. Rustomjee made the following concluding statement:

> I would like to thank colleagues for their valuable comments, which I will communicate in detail to my authorities. I would also like to thank staff for their solid work in an environment of cooperation with the authorities despite the difficult conditions in the country. The clear message arising from the discussion is that the authorities have been doing relatively well, but further progress will be needed in a number of areas.
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> On the military-social expenditure balance, while Directors have welcome recent developments in this area, they have also stressed the need to continue to monitor the situation to ensure that military expenditures are reduced further, as these are still high by regional standards. Box 1 in the staff report provides good indication of the extent of the adjustment already achieved by the authorities in this area, with defense expenditure falling from birr 6,800 million in 1999/00 to an estimated birr 3,700 million in 2000/01. Under the revised program, the authorities intend to cut this figure by half in 2001/02, which represents a further significant adjustment. At the same time, poverty-targeted expenditures have risen sharply, reaching even higher levels than before the war, which is remarkable considering that Ethiopia has always had a reputation for spending sizable amounts on poverty and for the good quality of these expenditures. In the revised program for 2001/02, poverty-targeted expenditures will represent 13.5 percent of GDP, up from an 8.9 ratio in the pre-war period. We hope that issues of absorptive capacity of poverty-targeted expenditures will not emerge if this trend of impressive growth continues as expected.
>
> Regarding financial sector restructuring, many Directors have emphasized that this should be pursued vigorously, and that it should be broadened to cover not only the banking sector, but also insurance and other sectors. Directors are generally encouraged by the CBE's restructuring

process, and they have outlined the benefits to be obtained from pressing ahead with CBE reform and privatization. There have also been comments about the need to carefully time the entry of foreign banks in order to allow the authorities to improve financial supervision and to allow domestic banks to adapt to increased competition. As Mr. Chelsky has indicated, perhaps an approach of gradually opening the sector to foreign competition could provide an intermediate solution. Mr. Zakharchenkov has also stressed the need to ensure that the reform of the CBE—which will almost certainly be included as a completion point trigger under the HIPC—provides a lasting solution to the bank's solvency problems, and are clearly specified to allow the staff to adequately monitor the completion of this action. Supervisory capacity also needs to be strengthened, as Mr. Callaghan and other Directors have pointed out, and the issue of nonperforming loans will also need to be addressed.

On the fiscal front, the Directors' support for the fiscal measures taken thus far is welcome, although much remains to be done in this area. The point made by Directors regarding the need to ensure that tax reforms are pro-poor is vital, and I will clearly convey this point to my authorities.

I will also convey to the authorities the concern from some Directors that progress in preparing the PRSP has been slow. The consultative process should be strengthened and evidence of progress will have to be provided before the HIPC decision point can be reached. The staff has already explained that the completion of the PRSP could be delayed by a few months. In the area of privatization, we will also stress to the authorities the need to focus on those public entities with greater impact on the macroeconomic framework, rather than attempting to cover an excessively large number of enterprises. The need for more detailed work by the staff and the authorities in the areas of HIV/AIDS, reform of the civil service and the judiciary, and monetary policy will also be communicated to the authorities.

Generally favorable comments have been made about governance, although continued progress will clearly be needed in this area. The authorities will greatly appreciate the comment about the need to devote more resources to a central statistical agency. This is a vital area not only for Ethiopia, but also for all other countries in a similar situation. I will also bring to the attention of the authorities the questions asked about the apparently large amount of off-budget items and extrabudgetary funds, the issue of land tenure, and the need to reduce average tariff rates and the number of tariff bands.

The authorities are very serious about their reform efforts. They will continue to implement the PRGF-supported program effectively. They intend to persevere with their fiscal consolidation efforts, to continue improving monetary policy management, and to strengthen the financial sector and improve its competitiveness. Their intention to continue to adhere to structural reform is clear. The evidence that they are starting to deliver on this front provides reasonable assurance that they will not disappoint expectations.

To conclude, I would like to acknowledge the hard work carried out in the last few years by the resident representative, who will be leaving the country shortly. He has done an excellent job despite coming in at a difficult time. We are pleased that he is moving to another country in our constituency.

The Acting Chairman made the following summing up:

Executive Directors considered that Ethiopia has performed well under its PRGF-supported program. The economy has grown strongly in the context of progress toward peace with Eritrea.

Directors observed that fiscal performance was broadly consistent with the program. They especially commended the decline in defense outlays and the increase in social spending. At the same time, Directors stressed the importance of further fiscal consolidation, continuing to reorient budgetary resources from defense toward poverty alleviation, and accelerating tax reforms, including introduction of a VAT. They encouraged the authorities to proceed decisively with their plans to refine budget monitoring, particularly of military spending, and budget-reporting systems. They noted the importance of being able to monitor the impact of economic policies on the poor.

Directors welcomed the authorities' initial measures to improve monetary management and the functioning of financial markets, including the foreign exchange market. They encouraged the authorities to seek technical assistance from the Fund in this area. They stressed that far-reaching reforms to strengthen the financial sector and improve its competitiveness are critical. Directors considered that priorities include reform of the largest state-owned bank, namely the Commercial Bank of Ethiopia, particularly to reduce its predominance in the banking system; strengthening banking supervision; and increasing central bank autonomy. Directors noted the role that foreign banks could play in boosting competition, but a few Directors emphasized the need for a measured, well-prepared approach.

Directors encouraged the authorities to adhere to their agenda of structural reforms, including in the areas of public sector management and civil service reform, and privatization and private sector development. They welcomed the authorities' decision to reduce, by January 2003, the average import tariff and their intention to lower the number of tariff bands and the maximum tariff rate. They also welcomed the decision to establish a Federal Ethics and Anti-Corruption Commission.

Noting the threat posed by the HIV/AIDS pandemic, Directors urged the authorities to articulate and implement a full-fledged HIV/AIDS strategy as soon as possible. Directors also urged the authorities to proceed with the preparation of a carefully considered and comprehensive PRSP, with the full participation of civil society and development partners.

The Executive Board took the following decision:

1. Ethiopia has consulted with the Fund in accordance with paragraph 2(d) of the three-year arrangement for Ethiopia under the Poverty Reduction and Growth Facility (PRGF) (EBS/01/13, Sup. 2, 3/26/01) and paragraph 4 of the Memorandum of Economic and Financial Policies attached to the letter dated January 29, 2001 from the Minister of Finance and the Governor of the National Bank of Ethiopia, in order to review program implementation and reach understandings regarding the conditions for disbursements during the remainder of the first year of the arrangement.

2. The letter dated May 29, 2001 from the Minister of Finance and the Governor of the National Bank of Ethiopia (the "Letter"), shall be attached to the three-year PRGF arrangement for Ethiopia, and the letter dated January 29, 2001 from the Minister of Finance and the Governor of the National Bank of Ethiopia, together with its Memorandum of Economic and Financial Policies, shall be read as supplemented and modified by the Letter.

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

a. In paragraph 2(a) the words "and in Table 1 attached to the Letter, respectively," shall be added after the words "specified in Table 1 of the Memorandum and in the Technical Memorandum,";

b. a new paragraph 2(b)(iii) shall be added to read as follows:

"(iii) with respect to the third disbursement, that Ethiopia has not carried out its intentions with respect to the submission to parliament of draft VAT legislation, as specified in Table 2 attached to the Letter."

4. The Fund decides that the first review contemplated in paragraph 2(d) of the three-year PRGF arrangement for Ethiopia is completed and that Ethiopia may request the disbursement of the second loan referred to in paragraph 1(c)(ii) of the three-year PRGF arrangement for Ethiopia on the condition that the information provided by Ethiopia on the implementation of the measures specified in Table 3 attached to the Letter, is accurate.

Decision No. 12539-(01/81), adopted
August 1, 2001

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/01/80 (7/30/01) and EBM/01/81 (8/1/01).

5. 2001 ANNUAL MEETINGS—OBSERVERS

The Executive Board approves the proposal to invite observers to the 2001 Annual Meetings of the Boards of Governors of the Fund and the Bank, as set forth in EBD/01/62 (7/23/01).

Adopted July 30, 2001

6. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 01/14 are approved.

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAM/01/85 (7/27/01) is approved.

APPROVAL: November 7, 2001

SHAILENDRA J. ANJARIA
Secretary