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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 01/40

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**Executive Board Attendance**

H. Köhler, Chairman  
 S. Fischer, Acting Chairman  
 S. Sugisaki, Acting Chairman

**Executive Directors**

A. Barro Chambrier  
 T.A. Bernes

M.J. Callaghan

B. Esdar

R. Faini

V.L. Kelkar  
 W. Kiekens

O.-P. Lehmussaari

A. Mirakhor  
 A.V. Mozhin  
 H. Oyarzábal

M. Portugal

C.D.R. Rustomjee  
 A.S. Shaalan

**Alternate Executive Directors**

A.S. Alosaimi  
 A.S. Al Azzaz, Temporary  
 D. Ondo Mañe  
 P.H. Whitehall, Temporary  
 J. Nelmes, Temporary  
 D.C. Guinigundo  
 I.-K. Cho, Temporary  
 W. Szczuka  
 B. Siegenthaler, Temporary  
 C.-P. Schollmeier, Temporary  
 F. Haupt, Temporary  
 H. Vittas  
 D. Nardelli, Temporary  
 M.P. Bhatta, Temporary  
 R.A. Jayatissa  
 J. Prader  
 B. Repanšek, Temporary  
 A. Fidjestøl, Temporary  
 M. Lundsager  
 P.A. Brukoff, Temporary  
 E.S. Weisman, Temporary  
 G. Bauche  
 I. Mateos y Lago, Temporary  
 S. Boucher, Temporary

F. Varela  
 S.P. Collins  
 H. Hagan, Temporary  
 D. Taylor, Temporary  
 R. Junguito  
 A. Maciá, Temporary

S.A. Bakhache, Temporary  
 Liu F., Temporary  
 Xu J., Temporary  
 Y.G. Yakusha  
 A. Kapteyn, Temporary  
 M. Yanase, Temporary  
 G.R. Le Fort  
 R. Maino, Temporary  
 D. Vogel, Temporary

S.J. Anjaria, Secretary, A.S. Linde, Acting Secretary,  
 A. Mountford, Acting Secretary, J. Prust, Acting Secretary  
 T. Davidson, Assistant, R. Gudmundsson, Assistant  
 M. Schulte, Assistant, O. Vongthieries, Assistant

**Draft Report of the Managing Director to the International Monetary and Financial Committee on the IMF in the Process of Change**

Staff representatives: Boorman, PDR; Metzgen, PDR

**Togo—2001 Article IV Consultation and Staff-Monitored Program**

Staff representatives: Sarr, AFR; Masood Ahmed, PDR; Sayeh, IBRD

**Republic of Latvia—Stand-By Arrangement**

Staff representatives: Schiff, EU1; Mueller, EU2; Ebrill, PDR

**Sri Lanka—2001 Article IV Consultation; and Stand-By Arrangement**

Staff representatives: Carter, APD; Allen, PDR; Bell, IBRD

**Also Present**

IBRD: C. Leroy-Themeze, Africa Regional Office; R.K. Peters, Europe and Central Asia Regional Office; A.M Sayeh, Africa Regional Office; S.White, Poverty Reduction and Economic Management Network Office. African Department: G.E. Gondwe, Director; E.A. Basu, Deputy Director; I.S. Adenauer, B.H. Anne, X.H.C. Debrun, O. Doré, E.C. Harris, W.A. Ossie, B.A. Sarr. Asia and Pacific Department: Y. Horiguchi, Director; W.S. Tseng, Deputy Director; J.V. Carter, N.U. Haque, D.S. Kanda, J.-S. Lee, L.Y.M. Leigh. European II Department: J. Odling-Smee, Director; C.H. Beddies, J. Mueller, J.A. Schiff, T.A. Wolf. External Relations Department: D.R. Hawley, Y. Kamata, J.E. Mark, V.N. Shastri, K.L. White. Fiscal Affairs Department: A.M. Annett. Legal Department: W.E. Holder, Deputy General Counsel; K.M. Christopherson, H. Elizalde, M.B. Luedersen, B. Steinki. Monetary and Exchange Affairs Department: S. Geadah, I. Otker. Policy Development and Review Department: J.T. Boorman, Director; M. Ahmed, Deputy Director; M. Allen, Deputy Director; L.N. Ebrill, R. Glennerster, Y.A. Metzgen, H. Monroe, M. Singh. Secretary's Department: K.S. Friedman, P. Gotur, N.M. Hairfield, L. Hubloue, P. Ramlogan, S. Soromenho-Ramos, T. Turner-Huggins. Western Hemisphere Department: A.-M. Jul, M.D. Kaufman. Office of the Managing Director: A.A.E. Bertuch-Samuels, Special Advisor; S.B. Brown, R.S. Teja. Advisors to Executive Directors: J.M. Abbott, M.A. Ahmed, A.S.F. Atoloye, E. Azoulay, M. Beauregard, W. Cho, J.A. Costa, P.R. Fenton, N. Jadhav, M. Kabedi-Mbuyi, M.F. Melhem, J. Milton, L. Palei, H.E. Phang, S. Rouai, J.N. Santos, K. Sakr, I. Steinbuka, R. Villavicencio, R. von Kleist. Assistants to Executive Directors: S. Alcaide, S.A. Bakhache, V. Bhaskar, T. Belay, S. Bonomo, N. Budina, G.M. Campos, N.J. Davidson, G. De Blasio, V. de los Santos, M. di Maio, E. González-Sánchez, T. Hadded, K. Harada, C. Josz, B. Kelmanson, T. Koranchelian, E. Kornitch, K. Kpetigo, T.-M. Kudiwu, I. Kup a, S. Le Gal, R. Manivat, G. Nadali-Ataabadi, E. Nyambal, L. Ocampos, Y. Saito, S. Sharipova, U.F.O. Seyidzade, J. Sipko, Sugeng, Tong Y., M. Walsh, N. Yeritsyan, I. Zakharchenkov.



**1. DRAFT REPORT OF THE MANAGING DIRECTOR TO THE INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE ON THE IMF IN THE PROCESS OF CHANGE**

The Executive Directors considered the revised draft of the Report of the Managing Director to the International Monetary and Financial Committee (IMFC) on the IMF in the Process of Change (SM/01/108, 4/11/02; Rev. 1, 4/17/01).

The Managing Director submitted the following statement:

**Keeping the World Economy on Track**

In Prague, the membership of the IMF underscored that globalization requires, more than ever, international cooperation. This is now even clearer in light of the interdependencies and spillovers revealed by the current slowdown in world economic activity. First and foremost, the Spring Meetings should boost confidence that the global economy will regain new momentum, by demonstrating the determination of members to act in a timely and appropriate manner.

The deceleration of the U.S. economy—which served as the engine of global economic growth during the past decade—is faster and deeper than expected some months ago. Other regions of the world have not taken up the slack. Declines in world equity markets and the financial difficulties faced by Argentina and Turkey heighten further the risks in the global outlook.

There is room to maneuver to keep these risks from materializing. The major industrial countries in particular must be proactive. The U.S. Federal Reserve has demonstrated its determination to resist a further weakening of growth prospects, and the tax cuts now under discussion should help to underpin economic activity in the United States. With inflation risks receding, an easing of monetary policy would also be helpful in most other industrial countries. While members should refrain from hectic fiscal policy action, automatic stabilizers should be permitted to work. Beyond that, there is a need to build confidence by demonstrating the resolve to press ahead with growth-oriented structural reform, particularly in Japan and Europe. Forceful action to open markets and liberalize trade would be of benefit to all members. Emerging market and developing countries, for their part, should stay the course of structural reform and sound macroeconomic policies.

**Strengthening Crisis Prevention**

Following the Asian crisis, the IMF embarked on a process of reforms in many areas. The initiatives that have been taken—to enhance the availability of economic and financial data, to improve our analytical tools for assessing vulnerability, to strengthen domestic financial systems, to provide

guidelines for debt and reserve management, and to develop and implement standards and codes—have already laid good foundations to make the international financial system more resilient. These initiatives should be implemented with ambition and strong commitment of the full membership of the IMF.

But it is also clear that the IMF needs to work even harder to put crisis prevention at the heart of its activities. In particular, we have to find ways to sharpen our analysis, reach concrete conclusions, and use these more effectively in the Fund's policy advice, as well as in underpinning members' political will and ability to take early and pre-emptive action. And in this context, the risks for the global financial system from possible imbalances in advanced economies need to be addressed with the same vigor as those posed by developments in emerging market economies. Highest on our agenda for the coming months should be further work on early warning systems. There is a need to combine quantitative indicators of vulnerability with judgment from the field and from the markets, and to bring this in a systematic manner to the attention of management and the Executive Board.

The economics profession in general, and the IMF in particular, needs to do a better job of keeping up with developments in international capital markets. The new International Capital Markets Department should enable the IMF to deepen its understanding of, and judgment on, capital market issues. And the informal but regular dialogue with high-level representatives of private financial institutions, through the Capital Markets Consultative Group, will further strengthen our work on crisis prevention and resolution. I also believe that such a systematic dialogue can help build a financial culture which is oriented toward sustainable value creation, and helps mobilize forces within the private sector that countervail "irrational exuberance." It is time to start a work process to review in a systematic way the experiences with bubbles and disruptive volatility and on this basis to contribute to forward-looking financial markets policy. My advice is to conduct this work in consultation with the private sector.

Good policies are still the best precaution that members can take against crises. We must therefore seek ways to encourage countries to be ambitious in the adoption of good policies in non-crisis situations. It is time to make the Contingent Credit Lines (CCL)—an instrument to resist contagion in international financial markets—operational. This should be understood as a reward for countries with a strong track record of sound policies and institutional arrangements.

The further liberalization of capital flows remains an important goal. However, progress in this regard has to draw on the experience gained in the past. That means, in my view, that capital account liberalization must be carefully sequenced, in terms of timing and degree, with the development of a

sound domestic financial sector, including of adequate regulatory and monitoring frameworks. I have asked staff to work on this and to come up with a proposal for an operational concept, including practical suggestions on sequencing.

### Effective Tools for Crisis Management

A stronger focus on crisis prevention should help to reduce the frequency and severity of crises, as well as the need for more and bigger rescue packages. But no matter how much effort goes into crisis prevention, we must recognize that economic disruptions and crises cannot be ruled out in an open and dynamic global economy. The IMF has to play a central role in crisis management, which requires sound judgment, adequate financial resources, and instruments for this purpose. A basic operating principle is that IMF financing should not relieve debtors or creditors of their responsibility for the risks they take. And on this basis the membership, in Prague, adopted a framework for private sector involvement in the resolution of crises.

In my understanding, this framework is based on the recognition that, in an open market economy with a predominance of private capital flows and private sector investment, it is appropriate to rely as much as possible on voluntary, market-oriented approaches. This is all the more true and advisable if a country itself wishes to base its adjustment efforts on this approach. And this also has guided and is guiding our actions in the cases of Argentina and Turkey.

But there is also agreement among the membership that there may be exceptional cases where a more concerted approach becomes unavoidable. The Fund is in a process of defining the circumstances and criteria for such cases. Careful analysis and judgment are needed on a number of complex issues—including how to better judge debt sustainability and the risk of contagion; the comparability of treatment between official and private creditors; the process by which countries rebuild confidence and regain access to capital markets after a crisis; and the specific role of the IMF in this.

### Focus on the Financial Sector

With the successful conclusion of the pilot phase for the Financial Sector Assessment Program (FSAP), the Fund—in cooperation with the World Bank—has taken an important step forward to strengthen fundamentals in domestic financial systems. We are now in the process of defining the continuation of this program for at least 24 additional countries in each of the coming two years. Furthermore, the Fund has actively engaged in the review of Offshore Financial Centers (OFCs); and, most recently, the Executive Board has agreed on an ambitious work program to enhance international efforts to counter money laundering. These three elements together form a

comprehensive approach to strengthening the soundness of financial systems in member countries and, thereby, the international financial system as a whole. I consider these areas as a priority activity of a focused IMF and an important contribution to crisis prevention.

This approach will have its full benefit only if the elements are defined with the consent of the entire membership. Through working together in a cooperative manner, I trust that members will see that participation in these initiatives is in their interest, not least as a way to obtain sustained access to international capital markets. Recent developments have once again highlighted the need to focus the FSAP even more on systemically important countries. And I would like to underscore in particular how important it is that the major industrial countries lead by example, by participating in the FSAP and through their efforts to fight money laundering within their own borders.

### Conditionality and Ownership

Conditionality remains indispensable for safeguarding the Fund's resources by ensuring that they are used appropriately to promote adjustment. It is also clear that structural change is indispensable for sustained growth. But countries cannot do everything overnight. Thus, there is a need to decide on priorities, focusing the Fund's conditionality on those measures that are critical to the macroeconomic objectives of country programs. The aim of streamlining should be to leave member countries scope to make their own policy choices and thus develop the political support necessary for a sustained reform process, while tackling vigorously the main problems that have brought them to the IMF for financial support.

The process of reviewing conditionality in the Executive Board is moving forward constructively. We have agreed to proceed on the basis of interim guidelines, on a case-by-case basis, while keeping the issues that arise under careful scrutiny. We all agree that the objective is not to weaken conditionality, but to make it more efficient, effective, and focused. In the process, we will need to cooperate closely with other international organizations, and especially the World Bank. And we must also make greater efforts to help countries build the administrative capacity needed to safeguard the sustained implementation of structural reforms.

There is also broad agreement that the IMF must continue playing an active role in promoting good governance, both through initiatives that promote good governance across the membership—such as the work on standards and codes—and through specific measures to address particular instances of poor governance and corruption. In applying conditionality on governance issues, we will have to balance the need for decisive progress with the necessary respect for the sovereignty of member countries.

This is still a work in progress. The views of Ministers and Governors at the IMFC on the right balance among the various objectives will be a crucial contribution to this effort. The Executive Board will resume its consideration of conditionality after the Spring Meetings, on the basis of discussions at the IMFC, input received from outside the Fund, and a staff review of experience in applying the interim guidelines.

### Growth and Poverty Reduction

Jim Wolfensohn and I recently circulated a joint progress report on the efforts of the IMF and World Bank to assist our poorest member countries. These reflect our determination to work closely together, and with other institutions and donors, to ensure that globalization works for the benefit of all. It is clear that decisive progress in the fight against world poverty will be essential to safeguard world peace and stability in the 21st Century.

The Poverty Reduction and Growth Facility (PRGF) and the Poverty Reduction Strategy Paper (PRSP) process were introduced to heighten the effectiveness of our assistance by ensuring strong country ownership of poverty reduction strategies. While the track record is short, the PRGF-supported programs have already brought positive results, including better growth performance in a number of countries, as well as increased and better-targeted social expenditures. The PRSP process is increasingly welcomed by poor countries and the donor community, as a critical tool for developing and monitoring poverty reduction programs. At the same time, it is clear that this new tool is placing severe demands on the limited administrative capacities of low-income members. We are trying to be as flexible as possible on the time-frame for moving toward full PRSPs, to build on countries' existing consultative and planning mechanisms, and to encourage other international institutions and donors to harmonize their own procedures with this process.

In my discussions with authorities in poor countries, I have been encouraged by the growing sense of leadership and determination to address the home-grown causes of poverty. It is clear that an effective strategy to reduce poverty must start with and build on efforts by poor countries to improve governance and fight corruption, establish respect for the rule of law, end armed conflict, and provide a good climate for private investment. Based on that, the poor countries can and should ask for more decisive support from the international community—through debt relief, capacity-building, aid, and access to markets.

The IMF and World Bank have spearheaded an effort under the enhanced HIPC Initiative that has already brought debt relief to 22 countries in Africa and Latin America, and we are doing our utmost to see that it becomes available to the remaining eligible countries. In the process, we will heighten our efforts to address the special problems of post-conflict countries.

But debt relief is not a panacea. Credit is an indispensable element for economic development, and that is why, in the longer run, it will be crucial for poor countries to win the trust of investors in their ability and willingness to repay what they borrow. This also underscores the need to make good use of the resources freed by debt relief.

The potential benefits from enhanced opportunities for trade and more adequate levels of aid are far greater than the savings from debt relief. Thus, a crucial test of the credibility—both for governments in the advanced countries and for civil society—in their support for reducing world poverty lies in the willingness to open markets to exports from poor countries and to live up to the promise to provide 0.7 percent of GNP in official development assistance.

The IMF can and should play a role—within its expertise and mandate—to contribute to the achievement of the UN development goals. We are actively cooperating with the UN in the preparation of the Financing For Development event in 2002.

#### Capacity-building

Successful implementation of the initiatives now under way in the IMF will require increased support for capacity-building in member countries, because lack of implementation capacity is often a bigger constraint than lack of political will.

It is clear that the international community will need both to make increased resources available for this purpose, and to make sure that those resources are used in an efficient and well-coordinated manner. We are focusing and prioritizing the IMF's own technical assistance activities, to make most effective use of our limited resources, and strengthening our cooperation with the World Bank and donors. We are approaching member countries, and particularly the advanced countries, to provide expert resources and financing. These will need to play a crucial role, for instance, in the FSAP, in our work on standards and codes, in the strengthened approach to money laundering, in our assistance to post-conflict countries, and in our efforts to enhance implementation capacities in countries with PRGF-supported programs.

#### An Institution that Listens and Learns

I think it is crucial to develop further a culture of openness at the IMF. A lot has been done in publishing Fund documents, explaining Fund policies and enhancing the dialogue with the public. My personal experience is that listening to both political leaders and civil society in program countries helps us do a better job of understanding their problems and needs and designing programs to respond to them. And I am confident that the new Independent

Evaluation Office (EVO), under the guidance of Mr. Montek Singh Ahluwalia, will help further to reinforce the learning culture at the Fund and enhance the transparency and accountability of our work. The Executive Board should be commended for the manner in which it has handled the selection process and the ultimate decision.

Mr. Bernes submitted the following statement:

I found the Draft Report to be comprehensive and relatively balanced. In order to expedite our discussion on Friday, I thought it would be useful to circulate my detailed comments in advance of the Board meeting.

As a general comment, and consistent with our desire to enhance not only the transparency of the Fund's work, but also its clarity, I see considerable scope—particularly in Section G on Transparency and Accountability—to reduce the use of Fund jargon and excessive detail as well as to streamline a number of awkward sentences. Not only will this be appreciated by IMFC Governors, many of whom may actually have a chance to read the Report themselves, but it will make the substance of the Report more accessible to the general public.

#### Detailed Comments

Paragraph 4: To be consistent with our recent discussion on private sector involvement (PSI), this paragraph should be re-drafted to give its focus to the policy discussions we have had (i.e., not work that is underway) since Prague and the PSI work program in the period ahead. I question whether or not there needs to be mention of Argentina and Turkey in this paragraph, but if such reference is retained, it should not be preceded by the words "Most importantly."

Paragraph 11: I am concerned that the discussion of conditionality focuses excessively on the number of conditions and insufficiently on the substance of conditionality. For example, the observation that structural conditionality has increased substantially should be accompanied by the acknowledgement that most of this conditionality was warranted, and was consistent with the Fund's mandate and expertise. A further sentence articulating the areas in which this conditionality was introduced would also be helpful. Further, if backing for the assertion that structural conditionality has increased substantially is to be found "in particular, in a marked rise in the average number of structural benchmarks," I hope we can also make clear that the effort to streamline conditionality is not simply a "numbers game" but is an effort to focus conditionality on the actions required for a program to succeed. What is also missing from this paragraph is any sense that the streamlining of conditionality will also need to take into account constraints on the implementation capacity of members.

Paragraph 14: I found the paragraph that has been drafted on the Governance Review to be inexplicably defensive and negative as it relates to the Fund's involvement in this area. This is probably most evidenced by the fact that the paragraph starts off with a bolded sentence about the "tension" between the need to focus the activities of the Fund and of maintaining an appropriate role with respect to promoting good governance. This implication is that the integration of governance concerns into the Fund's work is in conflict with its "core activities," a conclusion which I reject entirely and which is inconsistent with the conclusion of the Board discussion on this subject. This sentence will need to be re-written. Moreover, to be consistent with the tone of the Board discussion, it would be more appropriate to lead off the paragraph with the second sentence.

Paragraph 17: The final sentence is somewhat confusing, particularly the last phrase which states that "...the member's ability to meet repurchase expectations would signal that the member's external position is stronger than would have been dictated by this requirement." What do we mean by "dictated by this requirement"? Will anyone outside the Fund understand what we are saying?

Paragraph 20: In the first sentence, rather than "vulnerability," a word such as "viability" or "sustainability" would make a better finish to the sentence.

Paragraph 21: The second sentence would benefit from the use of a verb.

Paragraph 24: I believe that Directors requested that the section on restructuring sovereign bonds also make reference to the use of mechanisms such as collective action clauses and exit consents, which are examples of the innovative approaches to restructuring sovereign bonds. I hope this view can be accommodated.

Paragraph 27: The second sentence leaves the impression that the Executive Board has tasked the Capital Markets Consultative Group (CMCG). It is my understanding that the CMCG is a consultative forum established by management and is not tasked directly by the Board. Perhaps the actions referred to in the text should be more clearly de-linked.

Paragraph 44: The list of areas in which TA is expected to contribute to the work of the Fund is incomplete. We should add the following from the Board paper: "...fostering of macroeconomic and financial stability in non-PRGF program countries, promotion of regional capacity-building initiatives (including training) and possibly regional integration efforts...". Also, in light of our recent discussion on Enhancing Contributions to Combating Money



Laundering, we should include reference to the priority given to the provision of technical assistance in this area.

Paragraph 49: It would be preferable to speak of a “step toward” rather than a “step in” greater ownership of Fund-supported programs.

Paragraph 54: The paragraph indicates that EVO is intended “to improve further the transparency of the Fund.” This is not the sole purpose of EVO. EVO is also intended to enhance our effectiveness, credibility, and accountability.

Paragraph 56: The purpose of this paragraph is unclear. One could easily interpret it to mean that the objective of the FSAP, for example, is to strengthen the Fund’s legitimacy on issues related to financial markets. This is clearly not the main purpose of the FSAP. The same point can be made with respect to OFC assessments and recent initiatives by the Fund to combat financial abuse. Here again, the text makes it sound like these initiatives are in place as training and legitimacy-building exercise for the Fund.

Paragraph 57: The reference to “macroeconomic and domestic policies” is unusual. Macroeconomic policies can be aspects of domestic policy. Should we consider using “structural” rather than “domestic”?

Paragraph 62: The characterization of financial-sector programs as the root cause of crises over the last decade in a range of countries is overly simplistic. Rather, what we have seen is the manifestation of problems with macroeconomic policies (including inappropriate exchange rate regimes) and/or inadequate governance in the financial sector. We should not leave the impression that the financial sector is the main source of problems, when characterizing it as a symptom of bigger problems may be more accurate.

Paragraph 63: The first sentence should include the notion that the FSAP helps countries avoid crises, as well as enhance resilience to them.

Paragraph 68: Consistent with what we have agreed previously, I would suggest we add the following after the second sentence: “Missions will also go to some of the main onshore centers.”

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

During the last six months, we have reiterated our broad concurrence with the Managing Director’s efforts to refocus the work of the IMF by defining its central goals and scope in preventing financial crisis and making globalization work for the benefit of all. In this regard, we very much agree on the Report to the IMFC on the recent advances of the reform process.

However, it may be necessary to make more explicit the exact purpose of this report. To the extent that the purpose is to advance a list containing all the main topics the Board has been recently working on, including their degree of progress and the goals attached to the different activities being undertaken, the report achieves its purpose. The list is comprehensive, the progress is substantial and the goals are clearly stated throughout the paper. On the other hand, if the purpose of the report is to update members of the IMFC, who are supposed to be already quite familiar with the Board agenda, on the nature of the discussions that are still open at the Board with a balanced synthesis of different views so as to give them the opportunity to further reflect on them, and if duly motivated, to contribute to the discussions with some views of their own, then the report in its present form could be improved.

Section II of the Report on Refocusing the Work of the Fund contains two main issues that are still under discussion, the streamlining of conditionality and the involvement of the private sector in the resolution of crises. Streamlining and focusing conditionality and enhancing program ownership are central topics for the success of reforms, and some progress is to be reported in this area. This issue, however, is still open, yet no nuances are presented as if the Board had already agreed on the main thrust of the proposed changes, changes that in turn are not made explicit.

The section on the involvement of the private sector, in turn, highlights the cases of Argentina and Turkey but the reference to why the catalytic approach was used in those cases, raises more questions than answers. In addition, the critical point on restructuring international sovereign bonds is in paragraph 24, when alluding to "processes," and it is unclear what this expression refers to, unless you have participated in the discussions, not only at the Board, but also on the exchange of ideas and views that led to the final summing up.

We understand that one of the objectives of the private sector involvement initiatives is avoiding moral hazard, so that private market participants face the full array of consequences of the risks they have taken, and another is to enhance the private sector participation in the financing of the program and of an eventual crisis resolution. In this regard, it seems odd that the paper includes, as part of the private sector involvement initiative, the blanket guarantee extended by the Turkish public sector to creditors of Turkish commercial banks. Extending such a guarantee on bank liabilities could be defended as a means of avoiding a bank run from happening, and taking the interpretation to an extreme, the guarantee could also be considered a preventive action. However, in no case it could be defended as a way to share program financing or crisis resolution, and, even less so, as a way to involve the private sector in facing the full consequences of their risk taking. Quite to the contrary, the guarantee represents the transfer of private risks to

the Turkish public sector and could be seen as an element that foster moral hazard and excessive risk taking going forward.

We support the focus on crisis prevention and the efforts to identify sources of financial vulnerability through the Report on the Observance of Standards and Codes (ROSC) and FSAP process and to adequately address them by a proper prioritization of technical assistance. International standards and codes are deemed important to overcome information distortions and risky practices that may lead to financial instability and crisis vulnerability. The Section on Standards and Codes could, however, be more explicit on the 11 areas considered important for Surveillance. Moreover, on the FSAP section, bullets 2, 3 and 5 of page 21, as well as the one in page 22, provide largely irrelevant information making the section too long. Finally, the work on indicators of vulnerability is also important. However, identifying the source of the problem should be seen only as a first step towards taking remedial actions for its resolution. Indicators by themselves are not sufficient to prevent crisis from happening, and a purely statistical approach lacks the necessary analytical content for an adequate definition of the remedial action

The report presents the wide range of initiatives under way, even to the point that one might wonder on the risks to weaken institutional effectiveness. The inclusion of new topics is not compensated by topics or subjects that are been discontinued, transferred to other institutions or left out from the agenda. In particular, the question of the division of labor with the World Bank is raised in different parts of the Report. Yet there is no explicit discussion on which areas are proper to each institution nor on the difficulties found in this critical point, if any, and what is being done to solve them.

In closing, the Managing Director Report is backed by a well-defined strategy that we support. We note, however, the lack of a more explicit presentation of some of the issues, particularly of those that are under discussion.

The Director of the Policy Development and Review Department (Mr. Boorman) stated that many of the comments in the preliminary statements would be incorporated in the final report, but a few points deserved further discussion. First, on Mr. Bernes's point regarding the acknowledgment that most conditionality had been warranted and consistent with the Fund's mandate and expertise, the staff would suggest adding to the report Table 3 in the staff paper on Structural Conditionality in Fund-Supported Programs (SM/01/60, Supplement 2, 2/16/01), which showed all the different areas that had been covered by conditionality—such as, fiscal sector, exchange rate policy, trade, privatization, and financial sector. That table clearly illustrated that most conditionality had been in the areas that were generally accepted as part of the Fund's mandate.

Mr. Mirakhor remarked that Mr. Bernes's suggested sentence should be formulated differently to avoid giving a false impression that all Fund conditions had been in line with its mandate and expertise. That impression might raise doubts about the justification for the review and streamlining of Fund conditionality.

Mr. Portugal supported Mr. Mirakhor's comment and agreed partially with the suggestion made by the Director of the Policy Development and Review Department. According to the recent staff paper, only 29 percent of structural benchmarks had been found to be critical to the objectives of Fund-supported programs, 44 percent of structural measures had not been implemented, and the 1979 Guidelines on Conditionality had not been fully observed. These findings did not lend support to Mr. Bernes's argument that most conditionality had been warranted and consistent with the Fund's mandate and expertise. Instead, the language of the Chairman's summing up of the Board discussion on Conditionality in Fund-Supported Programs should be used: "While some Directors observed that, by and large, the Fund's conditionality had remained concentrated on its core areas of responsibilities, others noted that the application of some conditionality outside these areas gave rise to concerns that the Fund was overstepping its mandate and expertise." On the question of whether it was a numbers game, the summing up stated, "A few Directors noted that this exercise should not be seen as a quantitative one, with the sole purpose of reducing the number of conditions in Fund-supported programs...". Therefore, if a table were to be added as suggested by the Director of the Policy Development and Review Department, it would be more balanced to add another table showing the percentage of conditionality that had been proven critical, important, and relevant, as well as a table showing conditionality that had been implemented and had not been implemented.

Mr. Shaalan noted that the proposal of the Director of the Policy Development and Review Department had considerable danger, as clearly pointed out by Mr. Mirakhor and Mr. Portugal. There was a concern that the effort toward streamlining conditionality would be fruitless, resulting in the same conditionality and continued mission creep. In that regard, the language of the summing up would be more appropriate.

Mr. Oyarzábal expressed his support for Mr. Portugal, noting that his points were factual and that more emphasis needed to be placed on the issue of quality, as opposed to the quantitative focus, with respect to the effect of streamlining.

Mr. Faini remarked that the summing up seemed to provide a common starting point, while avoiding reopening the discussion on conditionality. The Managing Director's report did not sufficiently reflect one of the areas of consensus that had been mentioned in detail in the summing up—the rationale behind the use of structural conditionality. The Managing Director's report only mentioned that the Fund had to streamline conditionality, but did not explain why structural conditionality played, and would continue to play, a useful role in the Fund's conditionality as a whole. Thus, one compromise, which was perfectly in line with the summing up, would be to add a paragraph explaining why structural conditionality had been, and would be, playing an important role in the Fund's operation, before touching on the need for refocusing and streamlining as comprehensively covered already in other parts of the report.

Another point that was missing in the report was cooperation with the World Bank, Mr. Faini continued. The report only emphasized the division of labor between the Fund and the Bank, but made no reference to cooperation, which so far had been very useful in the financial sector work and the HIPC (Heavily Indebted Poor Countries) Initiative. That point had been well noted in the summing up.

The report mentioned that the Board would review the Guidelines on Conditionality later in the year, which was not correct, Mr. Faini argued. In fact, the Board had not set a deadline for the review of the Guidelines, but would review conditionality in Fund-supported programs as individual cases were presented to the Board.

Mr. Bernes agreed with Mr. Faini that the summing up would be a useful fallback. As evidenced during the meeting of the International Monetary and Financial Committee (IMFC) Deputies in London, the complexity of the issue had led to a lengthy debate about the danger of "throwing the baby out with the bath water." One should thus be careful about how to proceed to ensure that the attempt produced some meaningful results, while avoiding misleading the public. As the report would be placed on the Fund's external website, the presentation had to be well balanced, with the nuances of the range of positions being adequately captured.

Mr. Bauche agreed with the suggestion to revert to the summing up and avoid reopening the debate. The paragraph proposed by Mr. Faini on the rationale for structural conditionality was appropriate and would provide a good balance of the general sense of the Board discussion. He also shared Mr. Bernes's views that it was important to clarify that streamlining conditionality was not simply a numbers game. In that context, the last two sentences of paragraph 11 should read: "At the same time, recognizing that the application of the principles in the note would involve considerable judgment case-by-case, Directors agreed that forthcoming arrangements should be examined as they are brought to the Executive Board, with a view to deriving lessons for future practice. Against this background, they also saw a need to clarify and strengthen the guidance covering the application of the various tools of conditionality." Reversing the order of the last two sentences of this paragraph would give a better sequencing of the methodology for the revision of the Guidelines on Conditionality.

Mr. Esdar observed that the Board had debated this point before; thus, the issue should not be reopened. The Managing Director's report was already 22 pages long; adding more sentences might not be desirable. Nevertheless, if that was the only alternative, the only sentence that should be added was the second sentence in paragraph 5 of the summing up, which states, "While some Directors observed that, by and large, the Fund's conditionality had remained concentrated on its core areas of responsibility, others noted that the implication of some conditionality outside these areas give rise to concerns that the Fund was overstepping its mandate and expertise."

The Chairman commented that the Managing Director's report should be presented in a more conclusive way, rather than highlighting the differences in Directors' views as in the summing up.

Mr. Esdar agreed that the sentence needed to be reformulated.

Mr. Collins, supporting the language in the summing up, raised some doubts whether the so-called umbrella report should have value added beyond what was reflected in the summings up, as the author's interpretation might not be fully consistent with the summings up, thus provoking questions. It would be safer to present the report as a compendium of the summings up of key policy discussions. There might be some areas in the current report that had not been covered by Board discussions and summings up, in which case they should not be included in the report.

On the specific conditionality section, the current text brought up-front the Interim Guidance Note, which had been issued before the last IMFC meeting, Mr. Collins added. It would have been more appropriate to start with the conclusions of the Board discussion, as appeared in the summing up. Then the report could state that Directors endorsed, for the time being, the Interim Guidance Note, which presumably had to be finalized in due course.

Ms. Lundsager agreed with Mr. Collins that the language and the order of the summing up should be followed. While avoiding highlighting differences in Directors' views as normally phrased in the summing up, the report should not be presented in such a way that all issues had already been agreed upon. In particular, the Board had not reached a consensus on the need for any revision to the Guidelines, as pointed out by Mr. Faini. Moreover, it would be important to indicate that the matter was still a work in progress and much remained to be done. In that context, it would be useful to add to the text the future work—the pending issues identified in the summing up—that the Board was going to discuss over the coming months before concluding the topic of streamlining conditionality.

The Chairman acknowledged that that it was suitable to stress that there was still a process under way and to indicate that there remained several issues to be discussed by the Board.

Mr. Mozhin noted that two useful concepts that were in the summing up were not reflected in the umbrella report. One was the notion of criticality versus relevance to programs' macroeconomic objectives—the point broadly discussed by the Board. The other was the notion of the burden of proof for the inclusion of specific structural measures as conditions in a Fund arrangement, particularly where those measures were outside the Fund's core areas. Both concepts were important and should be included in the report, as they showed how the consideration of the Board had evolved.

The Chairman concluded that the staff would take careful note of Directors' comments and make necessary revisions to the section on conditionality. However, as the umbrella paper was the Managing Director's report, he would assume responsibility if Directors felt that the message was not correct. As for the Ministers' discussion, the concept of ownership should be given utmost attention, as Ministers were well aware what was at stake, and that considerable progress had been made in that regard. From the debates thus far, no one had challenged that conditionality was indispensable, and there was agreement that in order to preserve macroeconomic stability and growth, structural change was needed. Key

questions were: how much could countries do in a limited time; were there any constraints in their political system; and to what extent the international community was able to deliver, for instance, in terms of technical assistance. While a comprehensive list of structural conditionality looked perfect on paper and demonstrated that the Board had performed its task, it might not be feasible in reality. Thus, there was a need for balance. From the financial perspective, all shareholders agreed that it was important to safeguard Fund resources to ensure the revolving character of the institution. However, based on the cooperative nature of the institution, the concept of conditionality should be built on support from within the country, including political bodies and society. A long list of structural conditionality for Indonesia had proven impractical, and had been publicly criticized. The way forward was therefore to prioritize conditionality and stand ready to lend support to the country's implementation of those priorities. In the case of Fund-supported programs in Africa, there were many cases where delays had been caused by the requests from the advanced countries for a number of studies on the reform of certain monopolies.

The main message of the Managing Director's Statement to the IMFC would be that conditionality was indispensable, that its structure had to be changed, and that that was an ongoing process, the Chairman continued. Ministers would be asked to offer advice on how to proceed in a reasonable way. At the same time, the concept of ownership would be emphasized as the basis for sustaining reforms. The right balance would be eventually found between ambitious, detailed structural conditionality on the one hand, and the reality and the need to have countries own the programs on the other.

Mr. Collins suggested that, on a procedural point, it might be more appropriate to issue the report currently discussed as a report from the Chairman of the Board to the IMFC, separately from the Managing Director's Statement. While the latter would serve as a cover note that might also reflect the Managing Director's views on the various topics contained in the report, the report from the Chairman of the Board would strictly adhere to the views of the Board, as reflected in the summings up.

Mr. Mirakhor argued that the Chairman of the Board was a member of the Board as well, though not a voting member, and thus his views could be reflected throughout the Board discussions. In that regard, the procedure suggested by Mr. Collins might not make any major difference.

The Chairman remarked that the Managing Director's report already reflected fairly the current status of the Board discussions and should not be regarded as a personal report by the Managing Director. The Managing Director's personal statement, which was being finalized, would be brief. It would take stock of what had been achieved thus far at the Board and what remained in the pipeline. After the current Board discussion, the report would be revised, taking into account Directors' comments—including those that were politically sensitive.

The Director of the Policy Development and Review Department (Mr. Boorman) took note of the suggestion by Executive Directors to follow more closely the language in the summing up, and reiterated that a table showing different areas of Fund conditionality would

be added so that readers could draw their own conclusions. The current report had already conveyed a sense that streamlining conditionality was a process; for example, it mentioned that the test of whether conditions were critical to the programs' macroeconomic objectives was not fully operational, leading to a proposal to establish real-time reviews for the Board to decide if the right balance had been struck in each program.

On the nature of the report, it had to extend slightly beyond a distillation of the summings up, so as to present some progress on the operational side after the issuance of the summings up as well, the Director continued. For example, after the conclusions of the Board discussions on the Financial Sector Assessment Program (FSAP) in December 2000, and on the Review of the Experience with Reports on Observance of Standards and Codes (ROSCs) in January 2001, there had been considerable progress in terms of staff operations. The report aimed to convey the sense of how the general policy discussions that had taken place at the Board had been translated into action.

Regarding Mr. Bernes's comment on governance that the acknowledgement of tension in paragraph 14 of the report seemed defensive, the staff intended to send a message that governance issues, such as corruption, could be pervasive problems and that certain criteria needed to be established by which the Fund could decide whether to intervene, the Director explained. The first sentence of the paragraph simply made the point that a difficult judgment had to be made when it would be appropriate for the Fund to intervene.

Mr. Bernes's comment on paragraph 62 of the report that financial sector problems were not the only main cause of crises was well taken, the Director said. However, in some instances, it had been financial sector problems that had been the root cause of crises. In a number of crisis cases, the initial trigger had stemmed from other factors—mostly macroeconomic imbalances—and had been exacerbated by weaknesses in the financial sector. The staff would try to reflect that as well.

With respect to cooperation and division of labor with the World Bank—a point raised by a number of Directors—there were references to that throughout the report, but the staff would suggest adding a separate paragraph in the introduction section summarizing the areas where cooperation between Fund and Bank staffs had proceeded well—including financial sector work and debt management guidelines—the Director concluded. There were also areas that were still works in progress, such as the phasing out of cross-conditionality in Fund-supported programs in the areas where the Bank was ready to take responsibility, in the context of the Bank's Poverty Reduction Sector Credits (PRSCs), and in the Bank's work on middle-income countries.

Mr. Mirakhor, supporting the suggestion of the Director of the Policy Development and Review Department, stressed that cooperation between the Fund and the Bank was a crucial issue, not only from a political standpoint that would require guidance from the IMFC, but also for the future work of the Fund. Without a clear-cut division of labor and more collaboration with the Bank, progress on poverty reduction, the HIPC Initiative, or conditionality could be limited. Along the lines suggested by the Director of the Policy Development and Review Department a clear paragraph should be added at the beginning



stating the four areas where the Fund had had a reasonably good track record of collaboration with the Bank—Financial Sector Assessment Program (FSAP), standards and codes, reserve management and the associated technical assistance, and debt management guidelines. However, there remained four crucial areas where there had been little progress on collaboration between the Fund and the Bank—conditionality, technical assistance, capacity-building, and the PRGF. As it would be a mistake to repeat the same experience with the Policy Framework Paper (PFP) process and the Enhanced Structural Adjustment Facility, it was important to move forward with political guidance from the IMFC.

The Chairman noted the important point made by Mr. Mirakhor, and requested that the staff draft the suggested paragraph along those lines. The process of enhancing cooperation with the Bank had so far been constructive in defining more clearly the responsibilities and accountability of the two institutions. For that process to continue, it would require increased awareness and attention among the shareholders of both institutions.

Mr. Collins remarked that the taxonomy used by Mr. Mirakhor was helpful and highlighted the fact that there was no reference in the current report to the HIPC Initiative, PRGF, or PRSPs, as if nothing had happened in the last six months. Although much of the progress on that front might take the form of implementation, rather than Board discussion, implementation should also be highlighted in the report. Specifically, there were some important developments in the Fund's collaboration with the Bank in terms of joint staff assessments of the PRSPs where guidelines had been developed and collaboration between the two institutions in the 22 HIPCs had improved. Therefore, a separate section on collaboration with the Bank in the context of the HIPC Initiative, PRGF, and low-income countries would be appropriate.

The Chairman agreed that the report would be more comprehensive if it also highlighted the core messages on the HIPC Initiative, although that topic was already included in the Joint Report of the Managing Director and the President of the World Bank.

Mr. Portugal agreed with the suggestion made by Mr. Collins. While that topic appropriately belonged to the Joint Report, for the sake of completeness, the Managing Director's report should also mention progress achieved thus far in that area. It would be appropriate to have a cross-reference to that Joint Report and to the staff papers on that topic as well. Paragraph 7 of the Managing Director's report made reference to the staff papers, but not to the Joint Report. Thus, a paragraph should be added, summarizing how many countries had reached the completion point and how much debt relief had been granted. That kind of message was of political importance.

The Chairman concluded that that point had already been agreed. One paragraph would be added containing the messages along those lines.

Mr. Liu suggested that the introductory paragraph should also mention assistance to post-conflict countries in the HIPC Initiative framework. The Board had had a serious discussion on that issue on April 11, 2001. Although there remained certain issues that would

require further discussion, some common understandings had been reached at that discussion and thus should be given appropriate attention in the opening paragraph.

Mr. Szczuka made the following statement:

I generally share the views expressed by Mr. Bernes in his preliminary statement that the report is comprehensive and provides a broadly adequate picture of the efforts aimed at refocusing and streamlining Fund activities. Even though I would probably prefer to see a leaner or more parsimonious report, I understand that the comprehensiveness of the current draft may reflect the very broad spectrum of the issues discussed by the Board.

To deal with the concern that was raised in the statement of Messrs. Le Fort and Costa, I would suggest, as one of the possible options, to redraft the introduction in order to emphasize the main issues and directions of change and/or add a new paragraph presenting the most contentious issues and other topics still remaining on the Board agenda or, alternatively, the issues could be underlined in the cover note of the Managing Director, which would accompany the report.

As for the more detailed comments, I agree with the substance of most of the comments made by Mr. Bernes on the controversial issue of conditionality. I join the consensus on paragraph 11 that this should be presented as closely as possible to the summing up. Even though I understand the concern of Mr. Bernes that we should not suggest that conditionality is wrong because of the large number of conditions required, this is not the issue here.

I have also a small problem with the wording of paragraph 10, even though the reference in this paragraph regarding the shift from comprehensiveness to parsimony comes in a slightly modified form from the Board summing up, taken out of context, it might suggest a wrong contrast between something that is bad—comprehensiveness—and something that is good—parsimony. This is not the case. The shift is from redundancy or superfluousness and lack of macroeconomic relevance to improved effectiveness and focus on the Fund's core responsibilities. This direction of change could be emphasized in paragraph 10, as opposed to this rather false contradiction between parsimony and comprehensiveness.

While I agree with Mr. Bernes that the paragraph on governance could benefit from some redrafting, I do not find it so negative and defensive in its present form, and this was mentioned by the Director of the Policy Development and Review Department.

I also see some problem with Mr. Bernes's proposal to include money laundering among the top priorities of the Fund's technical assistance, because

it was rather clearly stated during the recent Board discussion that the Fund does not have either any special expertise or many resources to offer in this particular area.

On some other issues, I share Messrs. Le Fort's and Costa's view that the description of the FSAP guidelines is too detailed and could be somewhat streamlined.

The important issue from my point of view is the question of the presentation of the issue of private sector involvement (PSI). I think that all the paragraphs dealing with this issue—paragraphs 4, and 21 to 27—should be substantially redrafted to reflect the outcome of the Board discussion on the now abundant PSI reports. That is an issue that has not been mentioned in the Managing Director's introduction or in the comments from the Director of the Policy Development and Review Department.

I also found the presentation of the HIPC Initiative issue in paragraph 7 as being only a subset of the work on strengthening the financial architecture rather unusual. I agree with Mr. Collins's comment that the HIPC Initiative and anti-poverty efforts should be given more prominence in this report by the cross-reference to the other more comprehensive report.

On paragraph 67, dealing with OFCs, I found it quite surprising that there were 17 missions that traveled to OFCs without even attempting to assess their financial supervision, or even to mention the broader issue of the viability of the financial sector. This may create an impression that they were just traveling there but not doing any substantial work. I think it is not the picture we would like to present.

To conclude with a small point on paragraphs 17 and 18, I am not sure whether the use of such conditional forms as "would be expected" or "would begin" is appropriate to describe the situation after the Board decision on repurchase expectations. This is a condition they have to meet; this is not conditional.

Mr. Lehmussaari made the following statement:

I think that, in general, this umbrella report gives a fair account of the Fund's activities since the last meeting of the IMFC. But, at the same time, I agree with many of the points made by Mr. Bernes in his preliminary statement. I believe there is still room to streamline the text in order to improve the clarity of the report for non-staff, non-Board readers.

Like Mr. Bernes, I also have problems with paragraph 4 of the report. I believe the paragraph overstates our progress in implementing private sector

involvement in practice. I think the discussion concerning Argentina and Turkey should be further scaled down.

I have two additional points regarding crisis prevention and private sector involvement (PSI).

First, crisis prevention is briefly mentioned in the introduction, paragraph 2, and initiatives addressing this issue have a place in the report. In particular, there is a section on external vulnerability. But, the fact that crises prevention is at the heart of the Fund's activities could be strengthened even further. The fact is that the major share of the Fund's human resources is engaged in this work.

Second, on PSI, let me first emphasize that this chair attaches great importance to PSI. It is therefore very important that the report gives a fair account of the progress achieved since the last IMFC meeting. As far as I can see, we have made very limited progress on PSI since then. In view of the limited progress, it is particularly important, at this stage, that we clearly indicate what we intend to do about it. I think the short, rather summary paragraph on future work, that is paragraph 27, falls short of this objective. In a nutshell, the paragraph describing future work on PSI is very weak and, in my view, we should beef it up, and here I agree with Mr. Szczuka.

Ms. Lundsager made the following statement:

I think that the report was very good and comprehensive in showing that the Fund has made considerable progress on a number of issues, and putting it all together reminds us all that we have done a lot and we are making progress, and that will be a very good message to convey to the world.

I had a couple of additional points on conditionality. I remember when we had our discussion in the Board and we discussed about programs that already were underway. There was a basic understanding that conditionality would not be revised midstream or during quarterly reviews. However, paragraph 10 mentions "in the context of reviews of programs" where the new guidelines are being implemented. That was not exactly my understanding when we had our discussion on conditionality. So, I am not sure if it is appropriate to have what is in parentheses there in paragraph 10.

On the governance point in paragraph 14, I took the same negative impression that Mr. Bernes did when I read that paragraph, and I do not think that is the impression we want to convey. So, I agree with him. I think it would be useful to say something along the lines of the discussion on governance issues—pointing out the importance of maintaining a Fund role in issues that have a significant impact on the macroeconomic framework and/or credibility of a country's overall reform effort, even as the Fund seeks to focus

its work. I think that would be useful to indicate that this is very much at the core in some of our country programs.

Regarding Fund financial facilities, I thought Mr. Szczuka had a very good point on Post-Program Monitoring (PPM). We also took it that the sentence in paragraph 20 should make clear that the Board's view that PPM would be, rather than could be, useful, since we think that, generally speaking, there is a presumption that where there is a significant amount of access outstanding, there will be PPM. We have certainly seen that in terms of implementation so far. We have had so far three or four discussions on PPM.

It would be helpful if the report could reflect the language of the Guidance Note on implementation which states, "the Managing Director would be expected to recommend PPM to the Board unless, in his view, the member's circumstances were such that the process was unnecessary, and there would be a clarification of why that was the case."

The section on PSI in paragraph 26 should be deleted. So far as we can tell, none of the Fund's work has led to agreed conclusions on the assessment of medium-term sustainability. This is something we are still working on. I do not know that we have agreed on what identifies medium-term sustainability, so we were not certain if this paragraph was helpful.

Also in paragraph 27, the last sentence mentions the research paper on moral hazard associated with Fund adjustment programs. We are not exactly sure what work is under way, and perhaps we can be reminded. If it is not clear that there is something really definitive going forward, perhaps we should not be raising it. I just raise this question in terms of not being exactly sure what is under way.

On the external vulnerability section, we liked Box 1 and the sentence that says, "IMF staff reports are focusing more incisively on the issue of external vulnerability and core vulnerability indicators are now systematically included in these papers." This is really important, and I think Mr. Lehmussaari has just brought out the point that a lot of our work is aimed at crisis prevention and crisis resolution, and has noted that it needs to be highlighted more. I took that away quite clearly, but it might be useful if Mr. Lehmussaari read it as being somewhat diminished. We do not want that impression out there, because that certainly is at the core of what we have been doing.

I also want to raise one question. Paragraph 36 mentions the dissemination of early warning system data, and I know that, in Article IV staff reports, we have indicators listed and many countries have agreed to publish Article IV staff reports. However, in a discussion on World Economic and Market Developments (WEMD), the Economic Counsellor would discuss

indicators in different countries; that, as I understand it, is not made public. Our WEMD discussions are private discussions. If we are raising expectations in this document by referring to something that might be referencing our more private conversations, there will then be a more general question if we should be publishing everything we do on vulnerability indicators. This is only a question for the Director of the Policy Development and Review Department how that might be interpreted.

I would also think that it would be useful to include a reference to macroprudential indicators somewhere in this section, since that is part of our ongoing work as well.

Turning to standards and codes, we noted in paragraph 38 references that Directors in the Fund and Bank have endorsed the list of the 11 areas where standards are considered for surveillance. In our recent discussion on money laundering, the Board recognized the importance of the FATF 40 recommendations on money laundering, which is the twelfth key standard identified by the Financial Stability Forum (FSF) in its compendium. We think it ought to be reflected in this paragraph that that would make a contribution. I know that there is still work being done on how that will be included in the paper.

I note the call for research on the link between implementing standards and crisis prevention, which is mentioned in paragraph 38. We would like to highlight the usefulness of research and the extent to which private markets already take into account the implementation of standards, and the extent to which that is reflected in risk spreads. It would be useful to see how we are going to be trying to close that loop. The information on the potential cost savings to countries that implement international standards could be a powerful incentive, encouraging more movement toward that goal.

I have a few other technical comments, which I will be happy to convey to the staff.

Mr. Collins made the following statement:

I have already given my main comments on the HIPC Initiative and conditionality. I agree with most of Mr. Bernes's helpful statement. I would emphasize particularly his comments on paragraph 11 on conditionality and paragraph 14 on governance. Regarding paragraph 17 on repurchase expectations, where the phrase dictated by this requirement, we had a long discussion about how to phrase that, and I think it would be safer simply to take the language from the summing up.

For completeness, it could be mentioned that the Supplemental Reserve Facility (SRF) and, if there are any, the Contingent Credit Lines

(CCL), will be drawn up on the basis of meeting repurchase expectations rather than obligations. It would be worth drawing that contrast with the Stand-By Arrangement (SBA) and the Extended Fund Facility (EFF).

Reference to collective action clauses and exit consents in paragraph 24, as pointed out by Mr. Bernes, would be helpful. I think those are the main ones that I would particularly highlight from his statement.

I want to make a couple more comments. First of all, on PSI, I am disappointed about the way this is presented. For example, in the case of Turkey, the second bullet of paragraph 22 implies that getting the rollover agreements in place with the banks is in some sense an innovation. Of course, it is not an innovation; it goes way back to the debt crisis of the 1980s. But, more recently, Brazil was the model for Turkey with a difference. I think that, in the case of Turkey, there is this blanket guarantee. So, I agree with Mr. Le Fort that, if anything in the case of Turkey, it is rather a step back, because there is no genuine or additional PSI. Rather, it is domestic PSI, which would imply some kind of domestic debt restructuring. I think it rather oversells what the Fund is doing in relation to PSI in the case of Turkey.

I was also disappointed that there is no reference at all to work that has been going on—albeit not agreed in the Board yet and certainly not completed—in relation to standstills. There was reference to it in the last IMFC communiqué. I think it is an omission not to mention that this is an important issue outstanding with regard to PSI, and it is unfinished business. But, we are giving a progress report in a sense, and I think it is wrong to leave out any reference to it at all. I am not suggesting that the Board has reached any conclusions yet, but it is work that will be ongoing.

On money laundering, I would just like to endorse Ms. Lundsager's point, particularly about the FSF and the twelfth standard for Fund surveillance.

Finally, on reserves and debt management, I think paragraphs 30 through 35 are very helpful, including the Box. However, I would like to draw out the link between reserves management guidelines and debt management guidelines. That is implicit in Box 1, titled "A Quiet Revolution in Reserves Policies." The first paragraph mentions about the coverage of the new rule of thumb relating to short-term debt in relation to reserves as being a key indicator, but I think somewhere, perhaps in the introduction to the debt management guidelines section, it should be brought out that these ought not to be seen as two independent strands of thought. Although they have been developed separately, they should be considered together, and Bank and Fund staffs working on this topic are well aware of that and are trying to produce guidelines that mimic each other in format. We could bring that out, because ideally we are working toward a kind of a national balance sheet approach to

assessing countries' vulnerabilities, and this is a practical way of moving in that direction.

Mr. Szczuka wondered what the staff intended to suggest regarding the issue of PSI, as the text had apparently been drafted before the Board discussion on the draft report on PSI. It was agreed that the PSI section would start with progress on general issues, and perhaps with some factual references to the current crisis cases. It was not clear if the staff had tried to present it along those lines or in a completely different way.

Mr. Bauche made the following statement:

Overall, I find this draft reasonably balanced and I have only a couple of remarks, very close to those already made by Mr. Bernes, aimed at putting more emphasis on a few topics.

First, on the form of the report itself: it seems to me that because of its comprehensiveness, this report is quite difficult to digest for the general public and for IMFC Governors, who suffer from time to time from attention deficit disorders: for the next exercises of this kind, the utilization of tables and boxes would help improve the readability of the document.

On substance

In paragraph 4, I share Mr. Bernes's view that if the reference to Argentina and Turkey was retained (which would be questionable), it should not be preceded by the words "most importantly."

Still on PSI, it will come as no surprise if I say that we still believe that more emphasis should be put on this issue. To that end, I think the introductory paragraph on PSI, paragraph 21, should show that the current work has been undertaken in the continuity of our previous commitments, dating back before the Prague meetings. Therefore, I propose to add at the beginning of paragraph 21 the following sentence: "The IMF has pursued the efforts engaged in April 2000 on PSI" and here I would include a footnote making a reference to the IFMC communiqué of that time.

In the paragraph concerning future work on PSI (par. 37), several areas are mentioned that I can agree with, but I think that our recent Board meeting on PSI mentioned other avenues, such as operational issues relevant to the use of standstills, as referred to by Mr. Collins, that should be included in this report.

I also agree with Mr. Bernes when he indicates that the second sentence in paragraph 27 gives the wrong feeling that the Board has commissioned the Capital Markets Consultative Group. Actions undertaken



by that consultative group should not be linked to those of the Board, unless of course the Board has opportunities to get more involved in that group.

On conditionality, I share Mr. Bernes's views that we should make clear that streamlining conditionality is not simply a "numbers" game. In this spirit, and here I am referring to paragraph 11, we could change the order of the two last sentences of paragraph 11. It would read: "Against this background, Directors agreed that there was a need to streamline and focus conditionality and supported the general thrust of the Interim Guidance note. At the same time, recognizing that the application of the principles in the note would involve considerable judgment case by case, they agreed that forthcoming arrangements should be examined as they are brought to the Executive Board with a view to deriving lessons for future practice. Against this background, they also saw a need to clarify and strengthen the guidance covering the application of the principles of the various tools of conditionality." This way, I think we would convey a better sense of the sequencing of forthcoming events.

On standards and codes, I support Mrs. Lundsager's suggestion to incorporate a reference in paragraph 38 to the FATF 40 Recommendations as part of the list of important standards.

On the work concerning International capital markets, I would find it useful to have a brief reference to highly leveraged institutions and hedge funds, since I remember that the Board has recently benefited from informal discussions on this topic.

Mr. Callaghan made the following statement:

I can be brief, because, like others, I agree with nearly everything that Mr. Bernes outlines in his statement. On paragraph 11 on conditionality, the Director of the Policy Development and Review Department said he is not proposing a redrafting, but I think a redraft is required, because it comes across very much as a numbers game. The most important thing is the point that Mr. Bernes made in his statement that we have to focus on what is required for a program to succeed, and I think that was also in the Chairman's comments, which again I do not think are reflected in this draft. It is the general tenor of how we discuss the streamlining of conditionality. A general point that concerns us somewhat is that streamlining is regarded as an end in itself, where the focus should be on the overall objective and what is required for a program to succeed. To solve some of these problems by returning to the summing up is acceptable, but I think sometimes the summing up needs to be put in context—the point made also by the Chairman in his earlier remarks—including what are some of the problems that we see in terms of excessive conditionality and why it may relate to some programs' failures. Sometimes we need to package that up, because this will be a public document, and thus

it will be need to be read in context. I think it is important to have that elaboration in some of this.

In terms of the paragraph on governance, I do not see that there is tension more. We should only be involved in governance issues if they are relevant to the Fund's mandate. I read it in a rather negative sense, wondering what was that tension.

On PSI, I agree with Mr. Bernes's comments whether it is appropriate to refer to Argentina and Turkey in this report. Elsewhere, the report is really a general discussion about policies, and I wonder whether it is appropriate to refer to specific country circumstances. I also agree with Mr. Collins that we should be referring to the fact that there is ongoing work on standstills.

An area that we had some concerns was in the section on external vulnerability—Box 1 in particular. I do not think it is time to revisit the debt- and reserves-related indicators papers, particularly with no mention of the qualifications that were emphasized when this was discussed by the Board in May 2000. I think that there was quite a vigorous debate about the conclusions regarding reserves to debt indicators, and in that sense I suppose it was surprising to see it described here as a "quiet revolution." On the assessment of reserves adequacy, I think it was quite a vigorous debate and quite a contentious issue. I understand that, at the September 2000 meetings, the IMFC indicated the approach it would be taking to the Fund-based indicators. These references were carefully drafted in the September IMFC statement. They were adjusted, and there was only a passing reference to improving the vulnerability indicators. Again, our interpretation of events was that the Fund accepted that there is a degree of opposition to simple vulnerability measures, and it was not going to be promoting them as a rule of thumb. But, we recognize that there is going to be ongoing work. We would like to see at least the first paragraph of Box 1 reworked slightly to indicate some of the qualifications, and, if anything, we think that the paragraph in the text on this topic was more balanced.

Finally, the comment has already been made about the references to early warning indicators, and I think a problem is that we may be raising a degree of false hopes or expectations on the extent of the work and the extent of how we are using these indicators.

Mr. Portugal made the following statement:

This is a very good report. It is both comprehensive and concise, and it presents the issue in an objective, clear and balanced way. I also think it reflects the progress which we made since Prague which is very substantial; therefore, I have no major points or detailed suggestions because it is your

report. I could live with it as it is, but I have some comments on what other people commented and one or two comments of my own.

On the issue of conditionality, as I spoke, there were suggestions also to change paragraph 10. I think if that were acceptable, I would agree with the suggestion made by Mr. Mozhin on using the language of the summing up with respect to what comprehensiveness and parsimony mean.

On PSI, my impression is that the paragraphs in the report are already a reflection of the redrafting of the report to take care of the discussion that we had on the paper on the PSI, especially paragraphs 24 to 27, for instance. They are entirely new paragraphs that were not there before.

I have a few comments on this section. I think it would be a good idea to drop the reference to footnote 9, because this is the paper which discusses expansively about Argentina and Turkey, which we decided not to publish; therefore, I wonder if we are going to want to publish a paper that makes reference to that particular paper.

On paragraph 24, fifth line, where it says that if a country faces a severe liquidity crisis, then it would restructure. I wonder if we should not again on this area use the language of the summing up which instead of talking about the liquidity crisis which could be temporary, even if severe, we should say where the debt burden is unsustainable because that was the language that was used in the summing up.

On this question of further work that needs to be done, I would like to point out that Mr. Collins made the suggestion, supported by some, that we add the further work on standstills. Here again, if we go to the summing up there is a specific paragraph specifying what the work program in this area would include, and there are five bullet points there, and this particular one on standstills is not there.

Another suggestion that I have on these paragraphs on private sector work is with respect to footnote 11 regarding corporate workouts, mentioning that there is further detail in the paper. We are talking in the paragraph about what Executive Directors considered, but the details referred to in the footnote in fact are views of the staff given in a paper, which was never discussed formally. I would either suggest to drop the footnote clarify that details are of the staff's views on involving the private sector.

Finally, I agree with Mr. Bernes's suggestion on the desirability of improving the language of paragraph 54, which describes the objective of the EVO as simply one of improving transparency.

One last point, I am not sure I agree entirely with what Mr. Collins has said that there is a link between the debt management guidelines and the reserves management guidelines. One is a question of liabilities; the other is a question of assets. There is some link, but I would not agree to the link that he suggested, which is a national balance sheet approach. This has not been agreed in the Board. I would not like that to be explicitly mentioned in this report.

Mr. Collins, in response to Mr. Portugal's points, said that the work program on PSI, to which he had referred, was from the summing up of the Board discussion in August 2000 prior to the fall IMFC meetings. The IMFC communiqué of September 24, 2000, had referred to the possibility of standstills in extreme circumstances and that of the Fund's lending into arrears, and the Committee had urged the Fund to make progress to refine the analytical basis for the required judgments in that and other contexts. Thus, the issue of standstills remained on the Board's work agenda. The fact that the Board had not progressed much on that front in the last six months was regrettable but understandable. However, as that was an area of unfinished business, a reference to it would be appropriate for completeness.

On reserves and debt management, Mr. Collins remarked that he had not suggested a national balance sheet approach. Rather, his point had been that the two concepts were not completely separate; therefore, it would be helpful for the reader to consider both issues in the same context.

Mr. Szczuka agreed with Mr. Collins that the Board had never decided to remove the issue of standstills from its agenda. Therefore, the Board should continue working on this area.

Ms. Lundsager supported Mr. Portugal's comments on standstills, as the Board had not discussed the topic in depth nor had it made any progress. It would be preferable not to raise expectations in the Managing Director's report or leave the impression that the Board had made considerable progress, despite the fact that no agreement had yet been reached.

Mr. Mozhin noted that, from the technical point of view, giving prominence to the issue of standstills could be misinterpreted as the Fund's taking that approach to dealing with the crisis situation in Turkey and Argentina. While the Board had to work further on that matter, the Managing Director's report should not attach too much importance to such an idea under the current circumstances.

Mr. Bauche, while agreeing with Ms. Lundsager's point that there had been no progress on the standstill issue over the past six months, argued that the topic should be treated as a matter of unfinished business—the point suggested by Mr. Collins. As the IMFC had advocated further work in that area, it should appear as a work in progress. Regarding the point raised by Mr. Mozhin, it might be advisable to drop the references to Turkey and Argentina so as not to give the impression that the Fund's work on standstills had been applied to practical cases.

Mr. Shaalan commented that, while there should be more work on standstills, it would be a mistake to mention it at this juncture, as it might be misconstrued as part of the developments in Turkey and Argentina. The removal of the references to Turkey and Argentina, as suggested by Mr. Bauche, would not solve the problem, as the general public was aware of the problems in Turkey and Argentina and might associate standstills with those situations.

Mr. Portugal considered that the Managing Director's report was meant to reflect progress made by the Board, not to finish or solve unfinished business. In that light, it should reflect the main points in the summings up. While the Director of the Policy Development and Review Department was correct in saying that the Managing Director's report had to go beyond the summings up, insofar as the views of the Board or Executive Directors, or the work program of the Board, were concerned, the messages should not deviate from those in the summings up.

At the Board discussion on the Draft Report of the Managing Director to the IMFC on Private Sector Involvement in the Resolution of Financial Crises, Mr. Pickford had suggested that the issue of standstills be included, Mr. Portugal recalled. However, it had been agreed at that meeting that the report would reflect the summing up of the previous discussion on the work program. Although the standstill issue had been discussed, it had not been singled out as one of the bullet points in that summing up. Therefore, as pointed out by Mr. Mozhin, it should not be included in the current Managing Director's report.

The Chairman concluded that the standstill issue had not been, and could not be, forgotten. It had been mentioned both in the Chairman's speech at the Annual Meetings and in the fall 2000 communiqué of the IMFC that, in exceptional cases, standstills might be used as a last resort. However, at the current juncture, it would not be appropriate to mention it in Fund documents intended for the public. The matter was rather complex, and the forthcoming IMFC meetings would take place in a rather fragile global environment not seen in decades. In the meantime, the Board had to continue finding ways and means of operationalizing the concept; that had not yet been completed.

Mr. Oyarzábal, agreeing that it would be appropriate to tone down the idea, supported the proposal to delete entirely the references to Argentina and Turkey.

Mr. Lehmuusaari argued in support of Mr. Collins that, as the issue had not been forgotten—the point confirmed by the Chairman—it should be mentioned in the Managing Director's report that the matter remained on the agenda, so as not to give the impression that it had been completely disregarded.

Mr. Szczuka remarked that the process of making standstills operational would require many years, as it involved amendments to Article VIII and to domestic legislation in member countries; the crises in Argentina and Turkey would have ended by that time. In that light, there seemed to be no direct link between the standstill issue and the current crises. It was only proposed that the matter be mentioned as one item on the future Board's agenda,

not as one that was given particular prominence. Two options were available—either listing a broad spectrum of the Board's future work or not mentioning any of the future work.

Mr. Esdar commented that one should not confuse two different kinds of discussions. One was on the report to the IMFC on what the Board had done, and not what it had not done. The other was the future work program, which would be guided by the IMFC. Therefore, while the former did not discuss the issue of standstills, that topic still had to be considered in the IMFC meeting.

Mr. Rustomjee made the following statement:

The paper has touched on all the major activities in the Fund geared toward improving the effectiveness of the institution. By now it is generally accepted that the process of change that is taking place in the Fund should be in the direction of refocusing on the core mandate, improving coordination with other institutions and helping to ensure that the benefits of globalization are shared by all of the membership.

Regarding the issues already raised this morning, I agree with Mr. Liu in his comments on post-conflict assistance; with the suggestion of Mr. Portugal to have a cross-reference to the report on HIPC/PRSP; and with Mr. Shaalan, Mr. Portugal, Mr. Mirakhor and Mr. Esdar in their comments on conditionality. On the issue of numbers of conditions, from the experience of our chair, there have been too many conditions imposed in Fund-supported programs in low-income countries; these have taken little account of administrative capacity; and the numbers themselves do need to be reduced. I therefore very much agree with the use of the word "parsimony." It contains all the ingredients necessary to describe the approach we should be taking regarding conditionality: a responsible approach; the need for sensitivity to capital constraints; and the need for moderation after a period of excess. On this issue, I also agree with Mr. Shaalan that we should not be trying to fill your recent initiative on conditionality with holes. We really have made progress on this issue in the areas of consensus we agreed to in the Board discussion and I very much hope that we can retain and strengthen these as we go forward.

Aside from the above, I have three remaining comments on the paper. Firstly, regarding technical assistance (TA), paragraph 45, page 6, refers to Directors' expressing concern about a potential gap between demands for TA and the ability of the Fund to respond. I think this is more than a concern about a potential gap between demands for TA and the ability of the Fund to respond. The gap is real and it is large and for this reason I think we should drop the reference to the word "potential." And in listing the need for capacity building, we should add post-conflict countries and the paper on post-conflict countries itself clearly highlights the acute administrative and institutional capacity shortfalls in these countries. Moreover, in our view, the report should

state that while efforts will continue to be made to prioritize, consideration needs to be given to augmenting resources made available to TA.

Secondly, the last sentence of paragraph 45 ought to be made more clear by calling on the more developed countries to contribute to financing TA, rather than a generalized call to all countries.

Thirdly, the paper correctly states the Fund and member countries have done much in the last several years to increase the transparency of economic and financial data, and has established the framework for accountability with the institution of EVO and the recently appointed Director of EVO. The extent to which member countries have their country papers published on a voluntary basis, the publication of policy papers and the Chairman's summing following Board discussions on the policy issues have enhanced the transparency of the Fund's activities. However, as we have stressed on previous occasions, the cost and benefits of increasing transparency should be carefully weighted. In this regard, I wonder to what extent has the mandatory publication PRSPs and documents relating to the HIPC Initiative helped or hindered frank and open discussions between the Fund and authorities. I therefore fully agree with the content of paragraph 51, that the Fund Board should periodically review the policies and procedures of releasing Fund documents.

The paper also discusses at length the various initiatives undertaken recently to strengthen the Fund's financial sector work and surveillance, which include: an analysis of the activities in the international capital markets, the establishment of the International Capital Markets Department (ICM), and the continued interaction with the Capital Markets Consultative Group. Concerning the establishment of ICM, it is envisaged that this Department will play a crucial role dealing with systemic issues in the capital markets, and assisting member countries in gaining access to capital markets. It is particularly in regard to addressing the question of access to capital markets to all member countries that we welcome the establishment of the ICM.

Mr. Barro Chambrier made the following statement:

I agree with most of what Mr. Rustomjee has said, especially on the need to augment technical assistance resources and on the potential gap, as well as the need to take into account the administrative capacity and to continue work on capacity-building. I think that these points need to be linked to conditionality. However, streamlining conditionality, as Mr. Bernes has said, will go beyond reducing the number of structural conditionality, and I believe that we have to have further work on that.

It may also be appropriate to add a sentence about strengthening ownership. While the steps taken to streamline conditionality are well

outlined, it is not clear what is being done specifically to increase ownership, and therefore a sentence making a link to paragraph 49 will be useful to indicate that streamlining conditionality per se does not strengthen ownership, but it is complementary to efforts under way by countries to prepare, for example, PRSPs.

On the early warning system and vulnerability indicators, I wonder if the tone of this paragraph should not be softened, as it gives the impression that the Fund has developed an early warning system that can clearly predict future financial crises. It is not a correct impression, and some changes in the wording could help make it more realistic.

I took note that the joint report will mention the issues of HIPC, PRGF and post-conflict countries, but paragraph 7 may be too short and does not sufficiently capture the progress that has been made thus far. I would like to support what the previous speakers have said on that point. I also support the point made by Mr. Liu and Mr. Rustomjee on the need to have a reference to post-conflict countries, even though that particular point is mentioned in the joint report.

Mr. Kelkar made the following statement:

We broadly agree with the staff paper. There are only a few points that I would like to add for emphasis. Like Mr. Esdar, perhaps in the chapter on conditionality, it would be useful to have a paragraph on the future work program to indicate remaining issues that required further work and should be highlighted, such as program design.

Second, I also agree entirely with Mr. Rustomjee on technical assistance. I think perhaps that paragraph could be strengthened, particularly regarding the resource requirement for technical assistance. I also agree with him on the principle of parsimony. We cannot shy away from the fact that this is a numbers game. This has been conjured by external evaluators, analysts, and scholars. So, the parsimony principle is very important that needs to be highlighted.

Lastly, I also agree with Mr. Portugal's argument against the suggestion made by Mr. Collins to link the debt management guidelines with the reserves management guidelines. They are two different classes of problems that should not be mixed up at this stage.

Mr. Josz made the following statement:

I am not surprised that this report leads to a discussion. It is already tough enough to write a summing up of one discussion, and thus to try to capture all the nuances of the vivid discussions that the Board has had over the



last six months in a relatively short report is a major endeavor. Based on the position we have taken on all these issues of the Board, I can associate myself with many of the comments by Messrs. Faini, Bauche, Lehmussaari, and Callaghan.

The only point I would like to add is on PSI. I think the downsizing of the section on Turkey and Argentina is a welcome improvement, compared to the previous report on PSI. Nevertheless, when I looked at the old report, I still think that it would be worthwhile to drop the section all together, because it is the only country-specific section of the report. This is a report on the formal agenda of the IMFC and is meant to brief the IMFC on general policy issues. While specific country issues are not on the formal agenda of the IMFC, they may be part of the informal agenda. So, I think it is a bit odd to have only these two countries to characterize the progress on PSI, while no country references appear in other parts of the report.

I also agree that progress on PSI is pretty meager, compared to what was requested by the IMFC at the last two meetings. But, that is a reflection of the reality. So, the future work should be strengthened. We should also mention in the report that the future work will also depend on the restraint of the IMFC not to mislead the public, because this will be put on the web site. If people only look at the future work session, they will miss part of the picture, because the IMFC in its communiqué will also add some future work that may not yet be mentioned in this report.

The Chairman commented that the Turkish authorities had attempted to find a solution to their problems with the private sector on a voluntary basis, and from December 2000 to February 2001, their effort had been successful. Therefore, it was not quite correct to say that there had been no positive developments at all. He sought Mr. Josz's views with regard to the Turkish situation and PSI.

Mr. Josz reiterated that the Managing Director's report should summarize the Board discussions on policy items in general. At the last Board discussion on PSI in January 2001, the Chairman had indicated his intention to have the crisis cases discussed by the IMFC at the luncheon session, which was appropriate. Executive Directors would then have to brief their respective Ministers on the specific cases that would be addressed at that time to keep them fully informed. It would not be appropriate, however, to have a summary of those two specific country cases in the Managing Director's report, as it would be the only section where country references were made. It was not the language of the particular paragraph on Turkey that mattered. Other Directors had made a similar point. The Chairman's comment about the positive progress on PSI in general was supported.

The Chairman wondered if Mr. Josz considered that the rollover agreement, which had worked well in the case of Turkey, would continue to work after Turkey received assistance under a Fund-supported program. It had been a major effort, at least up to the present, and so far negotiations had not been concluded. The Turkish government attempted

to secure the rollovers again on a voluntary basis. A question was raised as to whether that would be an important contribution to the PSI process.

Mr. Josz agreed that that would help contribute to the PSI process. However, the Fund had other means of communicating that particular message to the public. What was at issue was simply the question of whether the current report on policy issues would be the right means of communications. It would be more appropriate to emphasize the views of the Fund on PSI in the context of Turkey by other means of communications.

The Chairman asked if there were to be a debt restructuring, what would be the difficulties that Turkey had to face.

Mr. Josz replied that he had no comment on that point.

Mr. Mozhin made the following statement:

Like others, I think this is a good report and I only have a few brief comments. I have already commented on conditionality. On the CCL, I felt that the first sentence in bold letters sounds somewhat self-congratulatory. I have a problem with the term "major overhaul," because the Board has already put in considerable time and effort to modify the design of this instrument and still has to continue working on it further. I wonder whether we could tone down the language somewhat.

On private sector involvement, I wish to support the suggestion made by Mr. Bernes and to mention the procedure of exit consents. I believe that it would send a signal that we really learned from the experience in Ecuador.

On the International Capital Markets Department, there is a list of tasks for this new department, and I wonder which department will be dealing with such long-standing issues as capital account convertibility and capital controls. Will they remain with the Monetary and Exchange Affairs Department or will they be transferred to the new department? Perhaps it would seem logical that the International Capital Markets Department will take over these issues, and if that is the case, it should be mentioned among its tasks—for example, to strengthen the Fund's ability to provide advice on orderly capital account liberalization and on the costs and benefits of using capital controls.

Finally, on offshore financial centers, I would agree with Mr. Bernes's proposal to send Fund missions also to the main onshore centers, not only offshore centers, because that is what is intended, I believe.

The Chairman responded that a unit within the Fund would be responsible for the issues of capital account liberalization and capital controls, but the task assignment was the

management's prerogative to decide, and thus should not be mentioned in the report to the IMFC.

Mr. Liu made the following statement:

I think the report is very good and well balanced, and I fully agree with it. I only have two comments. I already made my first comment during the discussion. The other one is on the debt management guidelines. Paragraph 34 correctly reports most of the consensus reached at the Board discussion in March 2001. I have only one point related to the voluntary nature of the guidelines that is not stated clearly enough here. In the Chairman's concluding remarks of that meeting, this voluntary nature was emphasized explicitly. Therefore, I would suggest adding one sentence in paragraph 34 saying that Directors also underlined the voluntary nature of the guidelines. I would also suggest changing the wording at the end of this paragraph from "in the context of Article IV surveillance" to "in the context of the Fund's surveillance" to better reflect the Board's understanding at that meeting.

Mr. Oyarzábal made the following statement:

On conditionality, I would like to support Mr. Mozhin's suggestion to clarify the terms "parsimony" and "comprehensiveness." I agree with most of Mr. Bernes's comments in his preliminary statement, particularly that on paragraph 14. With respect to PSI, I have already made my comments, and would support the exclusion of footnote 9, as suggested by Mr. Portugal.

On transparency and accountability, the last sentence of paragraph 46 states that the Fund encourages the publication of country documents. I was wondering if we should not also add a sentence saying that the Fund encourages the publication of country reports on financial sector assessment and on the observance of standards and codes, taking into account the issues of ownership and voluntariness. I think that this has been within the spirit of the Board discussion, and that it is a good opportunity to also encourage the participation of member countries in these two efforts.

Last but not least, I was wondering if it would not be proper to give more prominence to the EVO issue, as it is the attainment of an important goal that should be highlighted. There are four or five lines in that paragraph on EVO, which is factual, but there is considerable expectation with respect to EVO. Also, instead of mentioning that it will be operative by 2001, could we say September 2001 to be more specific and perhaps realistic as well?

Mr. Esdar made the following statement:

I also think that the report is well balanced. I have only two additional points. One is the question of external vulnerability indicators. In my view, the last sentence in paragraph 36 is somewhat misleading, as it seems to suggest the publication of the use of these indicators. The sentence says, "[T]he limitation of these models and of vulnerability indicators as crisis predictors, and concerns about the risk of self-fulfilling prediction of crisis, has necessitated continued caution in their use for Article IV surveillance." That, in my view, points to an issue of publication. If we are concerned, even if there is a risk that we may be wrong, we have to use them in the Article IV process, but have to be very careful not to use them publicly.

There is one other issue on technical assistance in paragraphs 44 and 45. I am not sure whether it reflects the summing up, but this point has been made quite frequently in the report, and the IMFC and the Development Committee provide the opportunity to spread the message on a broader scale. I think that, besides more technical assistance, we need, in particular, more effective and better-coordinated technical assistance. It would be a good idea to reflect this in the report or in the Managing Director's statement, so as to push the issue forward to the Ministers.

The Chairman agreed to note the last point in his statement.

Mr. Yanase made the following statement:

The report is very balanced and well written, so I want to limit my comments to those that are necessary.

On PSI, I have the same problem with Mr. Bernes, and I hope some changes will improve the quality of this paper.

I also welcome the suggestion made by some Directors and the Chairman to include a separate paragraph on cooperation with the World Bank and other institutions. The last point made by Mr. Esdar on technical assistance can also be included in that paragraph.

I would like to add one new point, which has not been voiced in this discussion yet. This is more of an editorial suggestion. The first part of the introduction says that the report provides an update on progress in refocusing the work of the International Monetary Fund on its core activities since the Managing Director's report in September 2000. Then it says that this report also discusses the work underway in strengthening the framework for private sector involvement in the resolution of crises. This gives me the impression that PSI is not one of the core activities of the Fund, while in the index, the

PSI topic is included in the section on refocusing the work of the Fund. So, I think it would be more appropriate to revise the introduction.

Also, given that this paper is not really a report on the Fund's activities, but basically a report on the general policy of the Fund, I think the formulation of paragraph 7, which discusses about HIPC Initiative-related activities, should be improved. The HIPC Initiative is also a core activity of the Fund, but, since it will be fully described in the joint paper, the Managing Director's report may mention briefly progress on Fund activities in this area.

The Chairman stated that Directors' comments, particular those in Mr. Bernes's statement, which had provided the basis for further discussion by other Directors, were helpful for improving the report and would provide Ministers a good basis for their discussions.

The Director of the Policy Development and Review Department (Mr. Boorman) said that there was fairly clear guidance as to how to modify the report and most of the comments would be taken into account. However, there were a number of issues that needed some clarification. First, on PSI, the section was a new addition, which had been drafted after the Board discussion on the Managing Director's draft report on that issue on April 12, 2001. The inclusion of Footnote 9 had been a mistake and would be deleted. With regard to the work program on PSI, the intent of that paragraph was to reflect the Board's work in the immediate future. The work on access to markets and the comparability of treatment between the Paris Club and private creditors had been under way for sometime and would be presented to the Board soon. The staff would suggest adding to the Managing Director's report a general statement, without any explicit reference to standstills, on the broader work program that would also be carried out, so as to solicit reactions from the IMFC in its discussions. Regarding the question of whether to include Argentina and Turkey and references thereto, the decision rested with the Chairman, as it was his report. However, there seemed to be tension, given that the work in Argentina and Turkey was the concrete manifestation of the policy that the Board had been trying to forge for sometime. The Argentine case, in particular, had brought to the surface some innovative ways of dealing with PSI insofar as the liability management aspects of the Argentine authorities were concerned in changing the debt profile in an important way that had saved almost \$3 billion in debt service payments for 2002. Thus, there was a good reason for the inclusion of the Argentine case, even though it was a specific-country reference and might not fit into the rest of the report. The staff would also include in that section references to exit consents and a collective action clause as elements of the additional discussions that had taken place.

Second, on vulnerability indicators, the staff's intention was two-fold, the Director continued. One was to develop the general work, principles, and analysis behind vulnerability indicators; and the other was to present some promising models or rules of thumb. The staff was careful not to simply use quantitative rules of thumb to characterize countries. The most dramatic case that the staff had confronted and the Board had experienced had been New Zealand. In many respects, New Zealand had been off the chart on some of the traditional vulnerability indicators, and there had been an extensive discussion

on that matter amongst the staff in its preparation for the mission to New Zealand with authorities, and subsequently in the Board discussion. That had led to a conclusion that, at the current stage, vulnerability indicators had to be used in an appropriate context. That context—apart from the World Economic and Market Development sessions—seemed to be Article IV staff reports, which had been the approach the staff had taken.

Third, on financial abuse and money laundering, the staff would add a separate section and a reference to that in the introduction, the Director indicated. Given the nature of that discussion and the way in which the Board had agreed to the summing up, the staff would be extremely careful to adhere to the language in the summing up.

Mr. Szczuka stated that the explanation of the Director of the Policy Development and Review Department on PSI compelled him to express even stronger support for the comments made by Mr. Bernes and Mr. Le Fort on the changes that needed to be made to the relevant paragraphs on PSI. It would be more appropriate to start with the general picture before referring to the specific cases, and not the reverse as was the case in the current report. Moreover, it was not correct for the Fund to regard the extension of a blanket guarantee by the Turkish government as a means of reducing vulnerability.

The Chairman agreed with the point made by Mr. Szczuka.

The Director of the Policy Development and Review Department (Mr. Boorman) acknowledged that it was logical to start with the general and end with the specific points. On the question of whether the extension of a blanket guarantee involved PSI, such a measure served to remove the specific counter-party risk regarding the banks to which foreign creditors had lent. However, it did not remove the country risk. The prevailing view was therefore that it remained definitely in the context of PSI.

The Chairman affirmed that the report would be redrafted in light of the current discussion. The Managing Director's Statement to the IMFC, which would be circulated soon, would mention the following points. First, the risks in the global economy would be one of the focuses of the Spring Meetings, and the issue would be how to keep the world economy on track with growth.

The second point was the strengthening of crisis prevention, which would be the focus going forward, the Chairman continued. In that context, further work would be needed on how to consolidate early warning systems already available in the Fund into a more useful operational tool for management and the Board, so that meaningful conclusions could be drawn out of certain developments. Another crisis prevention effort would be to make the Contingent Credit Lines (CCL) operational, to demonstrate that the Fund was moving in the direction of endorsing good policies implemented by member countries. As regards crisis management, the message had to be clear that the Fund's basic principle was not to assume the risks of creditors and borrowers as its own. While each crisis case had to be handled with due regard being given to its merits and specifics, a crucial element of the PSI process was the judgment on the prospects for regaining market access, as it was important for the Fund to work with markets—a source of growth, investment, and productivity. In that light, debt

restructuring should be used only as a last resort, and therefore should not be brought to the foreground of members' considerations. A focus needed to be put on more proactive options, namely, the market-oriented approach, which called for an early study on the criteria for the assessment of the prospects for the resumption of access to international capital markets. It was regrettable that progress in that area had been limited, but the staff had been overloaded with other work. In the meantime, the new U.S. administration could reflect on the issue and form its opinion.

The third issue to be included in the Managing Director's Statement was the financial sector, the Chairman related. That would cover the work on Financial Sector Assessment Program, offshore financial centers, and money laundering—a rather comprehensive approach to promoting sound financial sectors. This was, in a sense, crisis prevention and a core issue for Fund in the 21<sup>st</sup> century.

Fourth, conditionality and ownership was an issue of particular importance that required sustained support from the governments, the domestic political systems, and societies of member countries, the Chairman stressed. In that regard, it had to be acknowledged that member countries, given institutional constraints, could have limited capacity to implement conditionality. That did not mean, however, that the Fund would disregard the comprehensive approach to advising member countries. Rather, it should be made clear that, to avoid overloading countries with conditionality, prioritization of core conditionality was the key to success. Also, as emphasized by Mr. Rustomjee, technical assistance had an important role in building up administrative capacities for those needy countries. Mr. Esdar had also rightly underscored the need for a more effective, better-coordinated technical assistance process, which also included technical assistance provided by bilateral donors. During the recent visit to Africa, it had been observed that the PRSP process had offered a good vehicle not only for the enhancement of country ownership but also for the improvement of the coordinating process among donors and international financial institutions (IFIs). To that end, donors had to exercise restraint not to allow their own national or political interests to take precedence over those of the countries in need of support. While domestic political considerations were inevitable, the 21<sup>st</sup> century called for a higher degree of detachment from the domestic constituency. With that in mind, the joint report would highlight poverty reduction and growth, as well as the need to work together with the World Bank on the basis of a clear division of labor. That process had worked well in the context of the PRSPs in HIPC countries and other low-income countries through the Joint Implementation Committee. Nevertheless, an institutionalized approach was still needed to discuss and agree on major conditionality and the responsibility for the implementation of each type of conditionality.

The last topic in the Managing Director's Statement concerned the strengthening of the cooperative spirit in the Fund, which was the true strength of the institution's performance, the Chairman concluded. The above-mentioned points would constitute the basic structure of the Managing Director's Statement, which should offer a good basis for discussions by Ministers. The Statement would be redrafted in the light of the current Board discussion.

Mr. Shaalan commended that that had been an excellent summary of the points to be highlighted in the Managing Director's Statement. However, one element that seemed to be missing was the issue of market access by developing countries to industrial countries. While that might appear in the joint report on the HIPC Initiative, it would be useful to include that topic in the Managing Director's report to cover developing countries in general.

The Chairman noted that trade barriers existed not only in the advanced countries, but also within the developing countries. The industrial countries might not favor a coercive statement, but as market access represented the credibility case, that point would be added to the Managing Director's Statement.

## **2. TOGO—2001 ARTICLE IV CONSULTATION AND STAFF-MONITORED PROGRAM**

The Executive Directors considered the staff report for the 2001 Article IV consultation with Togo and the staff monitored program (EBS/01/49, 4/3/01). They also had before them a background paper on recent economic developments in Togo (SM/01/104, 4/6/01).

Mr. Barro Chambrier submitted the following statement:

My Togolese authorities are in broad agreement with the staff's analysis and policy recommendations, and they also appreciate the advice provided by the staff in the context of the Article IV consultation, and the discussions on a staff-monitored program.

Following three years of strong economic growth rate, moderate inflation and declining financial imbalances, Togo was hit by a number of shocks that started in 1998 and led to a deterioration in the economic and financial situation. The contraction in economic activity was due to adverse weather conditions that affected food production, an energy crisis that impacted negatively on most sectors of the economy, and a sharp decline in phosphate production due to technical difficulties, among others. The economy also suffered from the uncertain social and political climate associated with the implementation of the democratic process and the suspension of financial support by Togo's main donors and creditors. The disruptions in production and exports were the main factors behind the drop in revenue, while weak expenditure management and control caused outlays to increase, thus leading to a widening of the fiscal deficit. The reduction in external budgetary assistance also contributed to an increase in both domestic and external arrears.

In 2000, the economic and financial situation worsened as the fall in production in the manufacturing and mining sectors was compounded by a decline in cotton production. The slowdown in economic activity, financial difficulties at the state enterprises led to a higher fiscal deficit, and to further



arrears accumulation. This difficult situation also impacted adversely on the banking system, which continued to have liquidity problems. The difficult economic and financial situation has had a severe negative impact on the banking system's ability to finance crop credits or to address their non-performing loans problem. Moreover, a majority of the commercial banks were not in compliance with the liquidity ratio, and no bank met the portfolio structure ratio or the prudential ratios of the WAEMU Banking Commission.

With respect to the external sector, the contraction in export volume together with the deterioration of the terms of trade caused a worsening of the current account deficit to 14.1 percent of GDP, excluding official transfers. The oil price increase also contributed to the deterioration in the external current account deficit.

As regards structural reforms, the authorities have signed the concession agreement for the water and electricity company to an international private group. Decisive steps have been taken to accelerate the privatization of the banking sector, with progress also made with the telecommunications and postal services. However, there were delays as regards the program of privatization for the other public enterprises.

Against this difficult background, the Government that came to office in October 2000, moved quickly to introduce measures to correct the slippages that have occurred. As noted by the staff, there is a consensus within the new government team to strengthen public resource management and accelerate key structural reforms. In this context, my Togolese authorities have worked closely with the Fund staff to put in place, over the next six months, a set of policies that should help to regain control over the budget execution, and avoid any new accumulation of arrears. The government will also accelerate the implementation of structural reforms. My authorities have requested that the Fund staff monitor and follow up on the execution of this program. It is the intention of the authorities to use the staff-monitored program (SMP) to establish a track record of policy implementation that could lead to a program of adjustment and reforms that could receive Fund support under a PRGF.

In the context of the program, my Togolese authorities have already taken a number of measures. Thus, agreement has been reached between the Government and the public enterprises on the settlement of cross debts. The Tax Administration started making daily deposits of revenues collected at the central bank. As regards the banking sector, a technical committee has been established by the Minister of Finance to follow-up with the Privatization Unit and the Director of Portfolio on the restructuring of the three banks and one financial institution (SNI). For, the SNI and BTB, a tender letter has been finalized and will be sent to potential buyers shortly. For the UTB, an acting manager has been appointed to oversee its restructuring, and for the BTCL, all necessary documents have been prepared for its privatization, and the

government is awaiting the decision of the BNP, an important shareholder of the bank. Moreover, the government has made two payments to the World Bank in March to reduce the level of arrears. It has also made payment to the European Union in reimbursement of STABEX funds. In February, a presidential decree creating the national commission to combat corruption and economic mismanagement was signed. This commission will propose measures to streamline procedures and to combat corruption more effectively and improve the functioning of the judicial system.

Under the program, the Government will continue the consolidation for the public finances, and take steps to strengthen budgetary management. On the revenue side, since January 2001, strict measures have been taken to ensure that excise taxes are levied at the customs level the government increased excise taxes on tobacco products, alcoholic beverages, and cosmetic products in March 2001. It is expected that the total revenue in 2001 could increase by 9.1 percent. My authorities are well aware that due to the limited room for maneuver and uncertainty with regard to the timing of external budgetary assistance it becomes crucial to limit government outlays to revenue collection and available financing.

On the expenditure side, the authorities will ensure that budgetary allocations are consistent with staff recommendations. The new strategy seeks to eliminate the practice of ad hoc advances from public enterprises, revert to a more transparent management of public expenditure and discontinue recourse to the tax-compensation system between the treasury and public enterprises. The authorities are determined to put an end to the earmarking of budgetary resources, strengthen expenditure management by strictly respecting budgetary procedures and curtail the use of emergency procedures. The wage bill will be strictly controlled, and there will be no general salary increase. Moreover, only a few ministries will be allowed to recruit new personnel to fill the position of retiring civil servants. It is my authorities' intention to increase outlays for the health and education sectors and for the rehabilitation and maintenance of the infrastructures. The strengthening of the budgetary and treasury procedures will be pursued with a view to centralizing all Government and Government agencies' accounts at the Treasury. Meanwhile, key elements of revenue and expenditure in the budget will be monitored monthly. To further strengthen the compilation of economic and social data, the authorities have indicated their interest in participating in the General Data Dissemination System (GDDS).

The monetary and credit policies, which are conducted within the context of the regional monetary union, will remain prudent and consistent with the fixed exchange rate regime, as well as with the objectives of inflation and balance of payments. Efforts to reinforce the use of indirect instruments of monetary policy will continue, with a view to facilitating the effective control of the lending capacity of banks and to ensuring that interest rates are

determined freely by market conditions. As regards the banking supervision, my authorities have reiterated their support for the Banking Commission to ensure compliance by the banks with prudential ratios. The total outstanding non-performing loans remain large (CFAF 66 billion), including those of the OTP that account for 20 percent. More efforts are under way in the banking sector to ensure compliance with the liquidity ratio as well as the portfolio structure ratio and the prudential ratios of the WAEMU Banking Commission so as to halt the deterioration of the capital adequacy ratio for the sector.

The government plans to create in the near future an asset recovery company that will take over the non-performing loans, while measures will be taken to facilitate the rapid privatization of the banks. My authorities are hopeful that an agreement on a financial sector adjustment credit can be reached as soon as possible with the World Bank to cover the budgetary cost of the bank restructuring. The authorities consider that restructuring and privatization of the OTP is an essential step to prevent the resurgence of past problems with the banks.

An acceleration of the structural reform program is an important part of the SMP. In this regard, the authorities are implementing in a transparent and efficient manner the action plan agreed with the World Bank. The privatization of the banking sector is an important element of the privatization program, and as outlined above, important progress is being achieved. Progress is also being made in the privatization of Togo-telecom, and includes the establishment of the regulatory authority for telecommunications. The preparatory work for the privatization of the postal services has been completed. The privatization of the OTP remains a priority. A new agreement has been signed for a joint-venture company. It is expected that after an interim period, OTP will be privatized. The government is also working closely with the World Bank on action plans to privatize the Port of Lomé and the Railway company. The liberalization of the cotton sector is also being studied.

In conclusion, there is no doubt that the economic and financial situation of Togo is difficult. My authorities have indicated that they are firmly committed to address the constraints facing the economy and to embark on a strong medium-term program of adjustment and structural reforms. The measures already taken are clear indications of this commitment. The recent positive political developments are also indications that there is a strong determination to reverse past trends. Despite their efforts, the authorities remain concerned that prospects for external financial support, which is critical to any progress, remain uncertain. They are hopeful that good performance under the SMP and continued efforts, to normalize relations with creditors under difficult circumstances will lead to a positive response from the international community so that financial assistance could be increased rapidly to alleviate Togo's financial extremely difficult situation, and

contribute to the achievement of the program's objectives. In the same context, my Togolese authorities are hopeful that the SMP could be followed soon by a PRGF arrangement.

Extending his remarks, Mr. Barro Chambrier said that the authorities' commitment to transparency had been confirmed with their consent to the publication of the 2000 Article IV staff report and the Memorandum of Economic and Financial Policies.

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

Economic developments in Togo over the last few years highlight both the country's current susceptibility to political shocks and its heavy dependence on external assistance. Starting in 1998, the adjustment program went off-track due to several factors. In particular, the delicate sociopolitical situation that contributed to a loss of control in public finance and delayed the introduction of structural reforms. Furthermore, the contraction of agriculture and phosphate production—which together account for about 42 percent of GDP—widened the current account deficit to more than 14 percent of GDP. It was thus inevitable that poverty conditions in Togo have worsened over the last few years. These developments point the need to implement an ambitious reform program with a view to initiate a PRGF arrangement backed by the international community to support the efforts of the government.

At present, the political uncertainty caused by the forthcoming elections raises once again concerns on the new government's ability to pursue the economic reform program. While we recognize the difficulty of policy implementation in the current political environment, the restoration of confidence in the economy is key to improving relations with donors and attracting investment.

To this end, the new government is encouraged to make convincing progress on three fronts.

Given the rising debt to GDP ratio and the increasing debt-service obligations, the consolidation of public finances remains at the core of economic policy priorities in Togo. In this respect, the authorities need to focus their efforts on enhancing revenue performance, including by limiting exemptions, strengthening tax and customs administration, and increasing the rate of excise taxes on a number of imported goods. On the expenditure side, spending commitments should be contained within set limits in order to avoid further accumulation of arrears. Finally, we note that the weaknesses in accounting procedures hampered the management of public resources and the reliability of fiscal data. We therefore see the necessity of strengthening the credibility of the budgetary process in order to enhance confidence. We are encouraged by the authorities' commitment in fiscal consolidation, and particularly by the inclusion of several relevant measures in the 2001 budget,

and urge them to adhere to their plans, despite the political pressure associated with the forthcoming electoral process.

Improving the health of the financial sector is another important objective that is critical for economic recovery. It is a matter of concern that prudential ratios and the quality of banks' portfolios have deteriorated recently. Therefore, while we commend the authorities' move towards privatizing the main state banks, we urge them to take the necessary measures to strengthen the legal framework of the banking system and to improve the central bank's supervisory capability and its ability to enforce regulations. These measures will help enhance the soundness of the financial system and enable it to play an active role in financial intermediation.

The World Bank has suspended loan disbursements in Togo since November 2000 due to the accumulation of arrears. Making progress towards regularizing relations with the bilateral and multilateral creditors will help the Togolese authorities to pursue their structural reform program, and to start a PRGF arrangement. We therefore urge the authorities to contact all bilateral and multilateral creditors, in order to resolve the arrears situation and make progress on debt rescheduling, so as to obtain further assistance as soon as possible. In this regard, we are pleased to learn from Mr. Barro Chambrier's statement, that the authorities made initial reimbursements to the World Bank and the European Union.

To conclude, we find the Staff Monitored Program (SMP) an appropriate first step to help the Togolese economy achieve a sustainable growth and pave the way for a formal arrangement with the Fund. We also note that despite the fiscal consolidation efforts, the SMP will still entail a high financing gap of 10.8 percent of GDP that could only be filled with the assistance of the international community. Therefore, we call on the Togolese authorities to pursue with their reforms so that the donor community can extend financial resources to support the reform effort.

Mr. Rustomjee submitted the following statement:

I would like to thank the staff for their comprehensive and incisive report on Togo's economic performance in 2000 and the prospects for 2001 as well as Mr. Barro Chambrier for his detailed and comprehensive statement.

It is clear from the staff's report that Togo's weaker economic performance in 2000 was the consequence of domestic, external and exogenous factors. On the domestic front were prolonged uncertainties as well as inadequate and unsustainable policies in the privatization program and fiscal reforms. In addition, the relaxation of expenditure control in the face of revenue shortfalls coupled with the additional cost of hosting the OAU Summit accounted for the increased fiscal deficit in 2000. The delays

experienced in the privatization of some key public enterprises and the very substantial non-reforming loans in the banking sector also contributed to the slow-down in economic activities for the year. External factors included the impasse in the country's relations with the creditors and partners, including the European Union and the World Bank, compounded by the presence of overdue obligations, all of which hindered the flow of new loans and grants. Adverse weather conditions and the energy crisis of that year were additional exogenous factors which impacted negatively on most sectors of the economy.

Notwithstanding the above, we note several encouraging factors which will enable the authorities to reverse the recent economic decline. In particular, the authorities' commitment to avoid accumulation of new external payment arrears; to reduce the fiscal deficit from 5.8 percent to 5.1 percent of GDP and further improve tax administration by re-organizing the large tax payer unit and broadening the number of enterprises under its coverage. We are also encouraged by the authorities' commitment to accelerate the reforms in the financial sector and to restructure and privatize identified public enterprises under the World Bank supported program. Finally, the authorities have indicated their commitment to successfully implement the Staff-Monitored Program (SMP) and use it to establish a track record of performance to facilitate the negotiation of a PRGF-supported program. We would urge the authorities to strongly and urgently implement these measures all of which will contribute to reverse the recent economic performance.

We support the staff in their recommendation that the authorities should establish a permanent dialogue with the private sector on economic policy. This becomes pertinent in view of the important role of the sector in the financial reform (in the recovery of non-performing loans), in the proposed new income tax administration scheme, as well as in the adjustments in the import and exercise duties to reverse the declining trend in revenue. Indeed, in our view, this dialogue should serve as a spring-board towards the preparation of the proposed Interim Poverty Reduction Strategy Paper (I-PRSP). Of equal importance is the need to restructure the Office Togolais des Phosphates (OTP), which is Togo's main export earner. Restructuring will be particularly important as OTP accounts for 20 percent of aggregate non-performing loans of the banking sector. This will also be essential for the restructuring and resuscitation of the financial sector.

It will also be particularly important for the authorities to develop a stronger statistical base in economic data, especially in fiscal operations. The latter cannot be over-emphasized in view of the many lapses identified in the recent audit of treasury operations (Box 2). In this context, it is also clear that Togo will require considerable technical support, to improve the availability and timeliness of statistical data, to enhance the country's capacity for sound public expenditure management as well as for effective surveillance and program monitoring. We hope the authorities will expedite action in

addressing the deficiencies that will be identified in the recent Joint TGS-FAD mission in this regard.

We wish the authorities success in their future efforts.

Mr. Weisman made the following statement:

The Togolese Letter of Intent and Mr. Barro Chambrier's statement both begin by stating that the poor performance of the economy since mid-1998 was primarily caused by a number of shocks. The inference here is that elements beyond the control of the government cascaded out of control, undermining the fiscal, external, and banking-sector accounts.

But the summing up of the last Article IV discussion in mid-1999 clearly declares that the economic decline that had begun a year earlier was largely of Togo's own making. Specifically, the 1999 summing up notes regret, concern, and disappointment regarding lax fiscal discipline, the deteriorating and poorly managed banking sector, stalled structural reforms, and weakened relations with creditors. Twenty-three months later, paragraph 8 of the staff report before us today echoes the same sentiment and highlights the same problems.

Having said this, to address their difficulties the authorities have recently taken some initial steps as enumerated by Mr. Barro Chambrier. These measures, in concert with strict adherence to the targets of the SMP, would help form a suitable foundation for the negotiation of a PRGF arrangement. But the six-month timeframe of the SMP is very ambitious, especially in the run-up to upcoming elections. While we understand that the short time horizon of the SMP is designed to create a track record prior to these elections, more time likely will be needed to implement the structural measures and to establish a true track record of fiscal discipline as well as prudent domestic and external arrears management. Given that we do not want to rush a weak PRGF to the Board, can staff please comment on contingency plans should an adequate track record not be established within the allotted six months?

With regard to the rest of the paper, we are in general agreement with staff and will only make a few additional comments.

First, we would associate ourselves with Mr. Shaalan and Ms. Koranchelian with respect to their comments on the importance of fiscal consolidation, financial sector reform, and improving relations with the international community.

On the privatization agenda, we agree that top priority should be given to OTP, the weak management and poor governance of which has proved an

enormous drain to the economy. However, given that the divestiture of this enterprise has been an issue for many years now, we are very distressed that the privatization strategy proposed by the government is designed to take over three years and that the overall plan remains unclear. Can the World Bank representative address the outstanding issues and the seemingly excessively leisurely timeframe for the privatization?

Fiscal management has been very opaque, leading to a whole host of problems, particularly the build up of domestic arrears. As part of a broad effort to improve the transparency of budgetary operations, we urge the authorities to include the implementation of an independent military audit process that reports military spending to civilian authorities on an annual basis.

Appendix IV of the staff report highlights the weaknesses of Togo's statistics. We join staff in urging the authorities to strengthen their efforts in this area and encourage the government to participate in the GDDS.

Finally, we welcome the authorities' decision to publish these papers.

Mrs. Boucher made the following statement:

I thank the staff for their well-written report and confirm that we broadly share the recommendations and conclusions, and the proposed framework for the Staff-Monitored Program (SMP). As underlined in Mr. Barro Chambrier's comprehensive preliminary statement, the macroeconomic situation in Togo has continued to deteriorate seriously during 2000, due partly to unfavorable exogenous factors, but mostly as a result of the authorities' inappropriate policies. Poor management of the public finance situation and delays in structural reforms are unfortunately the predominant features of the past three years. The government that came to office in the last quarter of 2000 appears to be committed to break with these policies, and we share the staff's view that the new steps taken by the authorities are encouraging. The period ahead under the SMP is crucial for the country to regain credibility and restore its relations with the international community after the October 2001 election threshold.

The authorities must vigorously embrace the reform agenda. On the fiscal front, further steps to enhance revenue performance, strengthen budgetary management, and improve expenditure control are needed, while also complying with the privatization criteria. The country clearly needs to demonstrate more forcefully its commitment to contribute to the construction of the economic and monetary union.

On the structural front, further progress in the restructuring of the cotton sector and in particular the privatization of SOTOCO, will need to be



closely monitored by the authorities. Also, as underlined by the staff and other Directors, a clearer strategy on the future steps toward the privatization of the OTP should be laid out. In this regard, it could have been helpful to set a more precise structural benchmark on the privatization of OTP under the SMP. Restoring the production capacity and financial soundness of these enterprises is crucial to revamp the economy and to support the authorities' efforts in the restructuring of the banking and financial sector.

With these comments we wish the authorities every success in their challenging endeavors.

Mr. von Kleist made the following statement:

I generally agree with the staff's assessment and the policy recommendations presented in the excellent document before us today, as well as with the comments of Mr. Weisman and Mrs. Boucher.

Togo presents an insightful case study of how much easier it is for a country to slide down the slippery slope of bad governance and bad policies than to try to work itself out of a difficult but self-inflicted situation.

I support the authorities' request for an SMP. The main objectives to regain control over the execution of the budget, to make concrete progress in the privatization of banks and key public enterprises, especially the OTP, and to improve relations with donors and external creditors are appropriate but difficult to attain. I join the staff's call for transparency in the privatization process and urge the authorities to take the steps necessary for donors to regain confidence in them and in the fairness of the political process. Without the latter, renewed donor assistance will remain elusive.

The staff rightly emphasizes the need to establish a track record of at least several months and a resolution of the present impasse with major development partners before discussions on a PRGF arrangement could take place. In this context, it is important that there not be a further build-up of external arrears and that the currently existing arrears be cleared as fast as possible.

Mr. Nelmes made the following statement:

On balance, we agree with the policy recommendations in the staff report, and with the design of the staff-monitored program. The objectives of the SMP are well aimed at the major near-term challenges, and implementation of the policies envisaged in the SMP will send an important signal in terms of establishing the needed track record for beginning discussions on a PRGF arrangement. Like Mr. Weisman, however, we would not want to rush a weak PRGF to the Board.

Getting firmer control over the public finances is critical for Togo. On the revenue side, it's clear that the drop in tax revenues reflects more than just the slowdown in domestic economic activity. The authorities will need to strengthen customs administration and eliminate ad-hoc tax exemptions, as these destabilize budget control, reduce the credibility of fiscal policy, and contribute to a culture of non-payment of taxes that once ingrained can be extremely difficult to reverse. I agree with staff that an important signal would be given if the authorities were to revoke those exemptions granted for construction associated with the OAU summit.

On the expenditure side, I fully concur with the staff on the need to improve the overall governance and transparency of expenditures and expenditure management. Weak financial management, as was uncovered in the recent audit, undermines the ability of the government to effectively provide services in priority areas, and this will ultimately constrain the longer-term growth potential of the economy.

In this context, we would underscore the staff's advice to limit expenditure ahead of the October elections to available cash resources, and ensure that actual spending matches budget allocations. The economy cannot afford having the government divert spending from priority areas to finance election-related consumption. Sticking to the treasury cash flow plan will provide a good signal of commitment to improving fiscal governance and establishing the policy track record, and it will be required to facilitate efforts to settle overdue obligations to multilateral creditors and remain current on scheduled debt payments.

Indeed, the staff report highlights the important role that restoring normal relations with the World Bank could play in helping to address the problems in the banking sector. Banking sector reforms are critical, and long overdue. Like the staff, I welcome the recent progress that has been made in this area, and urge the authorities to continue their efforts.

Finally, given that problems in the banking sector are intertwined very closely with the situation at OTP, there is a pressing need to address the difficulties at this enterprise in a manner that is consistent with the resolution of the banking sector problems. It is clear that a restructuring and eventual privatization is required, and I would urge the authorities to be transparent about the recent joint-venture plans as part of its broader efforts to improve governance in the management of the public sector finances. Simply put, the public sector has a obligation to inform the public about what it is doing.

With these comments, we wish the authorities success.

The staff representative from the African Department (Mr. Sarr), responding to the questions raised by Messrs. Weisman and Nemes on the SMP, noted that the authorities had

expressed a strong interest in engaging in an SMP at the earliest stage possible. The authorities had taken the decision on the election date during the staff mission. They agreed with the staff that their performance would need to be monitored continuously on a monthly basis until the end of the year or until adequate financing assurances had been obtained. That would help avoid discontinuity in the program performance. The existing guidelines recommended a period of six months of adequate performance under the SMP. By June 2001 the mission would be in a position to reassess the situation and to recommend the necessary corrective measures to the authorities, if there were to be any slippages, so as to ensure that the program remained on track.

With regard to the issue of OTP, the staff representative expressed concern about the privatization strategy that had been proposed by the authorities, particularly in view of the considerable importance of OTP both for the fiscal balance and for the restructuring of the banking sector. In the view of the staff, the plan that had been presented by the authorities was not credible. It proposed that OTP should be managed by a private company for a period of 40 months before the eventual privatization would take place. During that period, that company would be in a position not only to restructure OTP but also to build a phosphoric acid plant. The information available to the staff at the current juncture was insufficient to judge whether the available financing means were adequate. The authorities had indicated informally that they were currently reconsidering the strategy, and the staff hoped to be in a position to clarify the situation soon. The staff representative from the World Bank could perhaps provide some additional information on the matter.

The staff representative from the World Bank (Ms. Sayeh) confirmed that the information currently available was insufficient to provide a full assessment of the authorities' privatization strategy. The Bank had been working with the Togolese government for some time to support their efforts regarding OTP. Under the Bank's most recent adjustment operation, whose second tranche had been released in 1998, the government had committed to privatizing OTP by offering 40 percent of its shares to the private sector. That strategy had not proceeded because the government had not found the forthcoming offers acceptable. Since then, the Bank had been advising the government on OTP in the context of a private sector project and had indicated that there was a need for a thorough reassessment of the privatization strategy. However, the most recent strategy presented by the government had been formulated without prior consultation of the Bank despite the fact that the Bank had been a longstanding partner in the efforts to privatize OTP. The Bank had subsequently proposed to the government to review the strategy jointly and to help them assess whether it was in the best interest of Togo. The authorities had not responded to the offer made by the Bank for technical assistance in that context, and the Bank had still not received the information that make it possible to field a mission. However, in a recent letter, the Prime Minister had informed the Bank that the prospective private partner was still in the process of putting together the financing required for reaching the interim management agreement. The Prime Minister had also indicated that the Bank would be kept informed of any progress in that regard. So far, the Bank had not received the information necessary to assess the progress made. The privatization of the OTP remained a central structural reform given its importance to the economy and to any successful bank restructuring in Togo. The Bank continued to advise the government that Bank support for

any eventual adjustment operation in Togo would depend on a successful resolution of the OTP issue.

Mr. Barro Chambrier made the following concluding statement:

I thank my colleagues for their meaningful comments and advice which will help my Togolese authorities to strengthen their policy measures. The staff has already adequately responded to the questions raised today.

From the discussion and our assessment it is clear that the Togolese authorities have made progress in the areas of macroeconomic policy and structural reform implementation under difficult circumstances. It is also encouraging to see on the political front that the newly-appointed government has taken a series of measures to restore confidence. This is a critical issue. The Staff-Monitored Program is indeed ambitious, and I would like to reassure my colleagues that it is not in my authorities' interest to have a weak program with regard to the PRGF. The purpose would be to accelerate the implementation of measures to avoid a further period without additional financial support that would weaken the authorities' effort to move ahead. If there are clear signs of the commitment of the authorities on the reform process, and if a reasonable track record can be established, we hope that the donor community could also move forward. This is also related to the need to respond to the European Union's request with regard to the elections. The authorities have demonstrated their determination to support the process in fulfilling the prior action for the SMP.

Most of the discussion focused on the OTP, and the authorities understand the need to consider the restructuring of the OTP as an essential step to prevent the resurgence of past problems with the banking sector. This is critical, and the OTP is also playing an important role in terms of the overall macroeconomic stability framework. The authorities are open to this protocol, but there will be further discussion with the Bank especially on that question, and we welcome the Bank's commitment to help our authorities. However, the solution proposed by the Bank in the past did not bring agreement. Therefore, there is a further need to discuss this important matter has to be taken seriously.

With regard to the need to strengthen the statistics, your comments are well taken. With the military audit and the need to pursue improvement in the banking system, I will faithfully transmit your advice and recommendation to my authorities. I am sure that they will be encouraged by your comments.

Let me conclude by again thanking my colleagues and the staff for the constructive progress made with regard to the SMP, and also for having a permanent resident representative in Togo. In the past, Togo has demonstrated its commitment, but we also have to take into account social and political

issues that are as yet unresolved. The need for the international community to move when all the conditions are met is also vital.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that, over the last three years, Togo's economic and financial situation had continued to deteriorate, reflecting mainly policy weaknesses and a difficult external environment. Real GDP growth registered low or negative rates over that period, while the fiscal and balance of payments imbalances increased substantially and the situation in the banking and public enterprise sectors deteriorated. Directors were concerned about the substantial accumulation of domestic and external arrears and the loss in private sector confidence.

Against this background, Directors welcomed the new government's determination to address the weak economic policies and performance and to accelerate structural reforms in 2001 under a program that will be monitored by the staff (SMP). They stressed that efforts to regain control over the execution of the budget, make concrete progress in restructuring the banking and public enterprise sectors, and to improve relations with external creditors would help lay the foundation for sustainable growth and poverty alleviation over the medium term.

Directors noted that the fiscal policy established under the SMP for 2001 would be a first step toward enhancing revenue performance, strengthening budgetary procedures, and improving expenditure control. They urged the authorities to persevere in their efforts to widen the tax base, to strengthen tax and customs administration, and to require public enterprises to comply fully with their tax obligations.

On the expenditure side, Directors urged the authorities to adhere to the treasury cash-flow plan, while underscoring the importance of spending restraint ahead of the October 2001 elections. Moreover, they encouraged the government to maintain critical levels of spending on health, education, and services for the poor, while strictly controlling personnel costs.

In light of serious weaknesses in accounting and financial controls at the treasury, Directors urged the authorities to ensure that accurate and timely information be provided on the operations of the public sector. Moreover, to promote good governance and fiscal transparency, budget procedures will need to be fully respected. Procedures for the periodic auditing of budget accounts and the exercise of parliamentary oversight should be in place in time for the preparation of the 2002 budget.

To redress the continued deterioration of Togo's balance of payments and the worsening external debt situation, Directors stressed the importance of addressing the root causes of the poor export performance in the cotton and phosphate sectors, and they urged the authorities to make every effort to remain current on their debt-service obligations and to begin settling the outstanding arrears to multilateral creditors, to speed up the resumption of external assistance.

In the area of banking and financial sector reform, Directors welcomed the recent efforts to disengage from the main state banks and from the SNI (National Investment Company) as a critical step toward improving the functioning of the financial sector and facilitating economic recovery. The planned creation of an asset recovery company that will take over the nonperforming loans of the banks and facilitate their rapid privatization will need to be accompanied by the restructuring of key public enterprises, particularly the phosphate company (OTP), and by a strengthening of the legal system in order to facilitate loan recovery and to avoid a resurgence of past problems with the banks.

Directors expressed concern over the substantial delays in the reform of important public enterprises, particularly the OTP, the Railway Company, the Autonomous Port of Lomé, and Togo-Telecom. They encouraged the authorities to implement the public enterprise restructuring action plan agreed with the World Bank. Directors also stressed the need to proceed expeditiously with the privatization of OTP.

Directors emphasized that establishing a credible track record of policy implementation will be critical for Togo to mobilize rapidly the financing assurances necessary for a program that could be supported by a PRGF arrangement.

Directors urged the authorities to press ahead with their efforts to overcome weaknesses in the compilation of economic and social statistics, particularly of public finance data, in order to eliminate the current difficulties for effective surveillance. The authorities' intention to participate in the General Data Dissemination System (GDDS) should help establish a framework for a broad-based improvement in Togo's statistical systems. In that context, Directors supported the provision of Fund technical assistance.

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

### **3. REPUBLIC OF LATVIA—STAND-BY ARRANGEMENT**

The Executive Directors considered a staff paper on the Republic of Latvia's request for a Stand-By Arrangement (EBS/01/44, 3/23/01), together with a report on the Republic of

Latvia's observance of standards and codes on fiscal transparency (SM/01/98, 3/29/01; and Cor. 1, 4/13/01).

The staff representative from the European II Department (Mr. Schiff) submitted the following statement:

Since issuance of the staff report (EBS/01/44), additional information has become available on macroeconomic developments, the fiscal and monetary performance during the first quarter of 2001, and structural issues. This information does not alter the thrust of the staff appraisal.

The macroeconomic outcome in 2000 was better than expected. Reflecting a strong growth rate of 8.7 percent in the fourth quarter of 2000, real GDP grew by 6.6 percent for the year as a whole, about a percentage point above the estimate in the staff report. Indices on industrial production and retail trade indicate that economic activity remained buoyant in the first quarter of 2001. Inflation remains low, with the CPI increasing by 1.4 percent in the twelve months through March 2001. The external situation in 2000 also turned out better than estimated. Reflecting continued strong exports to the EU and improvements in the income account, the external current account deficit declined to 6.8 percent of GDP, about half a percentage point lower than expected. The share of this deficit financed by foreign direct investment rose to 82 percent, compared to the preliminary estimate of 75 percent in the staff report.

The general government fiscal deficit and the net international reserves (NIR) and net domestic assets (NDA) of the Bank of Latvia were within the indicative targets set for end-March. The general government fiscal deficit amounted to LVL 9 million, about half of the deficit ceiling, with the authorities succeeding in containing expenditure in light of somewhat lower tax receipts. Parliament adopted the amendments to the excise tax law ahead of schedule, which bodes well for strengthening tax collections. In line with the commitments under the program, the Bank of Latvia reduced the monthly auction volume for two-year swaps to LVL 5 million beginning in April.

In the structural area, last week the government decided on the minimum bidding price for the privatization of the Latvian Shipping Company (LASCO), with the auction tentatively scheduled for May 11.

The Latvian authorities would like the staff report and the program documents to be published.

Mr. Lehmuusaari submitted the following statement:

My authorities would like to thank Mr. Schiff and his team for their guidance in maintaining macroeconomic stability and external sustainability

in Latvia. They are delighted that fruitful cooperation with the staff team has developed into a new economic program, and they welcome Mr. Mueller as a new mission chief.

At the outset of the new millennium, Latvia is witnessing brisk economic growth coupled with ongoing macroeconomic stability. These successful developments were backed by the sound and responsible economic policies of the Latvian government. Only three years have passed since the Baltic countries were severely affected by the Russian crisis. Meanwhile, the government effectively proved its ability to cope with external shocks by implementing a number of corrective measures which enabled the Latvian economy to return to a sustainable growth path. Looking ahead, the authorities are committed to meeting key economic challenges through a tighter fiscal policy and faster structural adjustment.

With its healthy growth rates and low inflation, Latvia has become one of the most rapidly developing countries in Central and Eastern Europe and is on a path towards real convergence with the EU countries. Since 1996, real GDP growth in Latvia has exceeded GDP growth in the EU (except in 1999), thus narrowing the per capita income gap. Moreover, Latvia's production structure is converging to that of the EU countries. Latvia also competes well in the international markets. In 2000, nearly 2/3 of total Latvian exports went to EU countries. By anchoring its economic, political, and institutional structures to those of advanced Western European nations, Latvia has improved its investment climate markedly. In 2000, foreign direct investment (FDI) inflows increased by 21.9 percent and constituted almost 6 percent of GDP.

Topping Latvia's political and economic agenda, EU accession has become one of the key driving forces behind the country's adjustment and reform efforts. Having met many of the criteria for membership in the European Union, Latvia is addressing the remaining challenges. Eleven negotiation chapters are provisionally closed, 24 are open and the country is looking forward to opening all remaining chapters by the mid-2001. The Government aims to complete the accession negotiations by 2003. Thanks to significant advancement and firm policies, the country is catching up to the first wave of the EU candidate countries.

#### Recent Economic Developments and Outlook

In 2000, growth reached the highest level in the Baltics at 6.6 percent, fostered by exports and investments. Growth was particularly strong in industries producing high value-added manufactured goods, such as shipbuilding and agricultural machinery production. Construction, transportation and communication industries, retail trade and, to a much lower extent, agriculture, also contributed to growth.



In most industries, wages grew more slowly than productivity, and productivity gains more than offset the recent real appreciation of the lats. Exports to the EU increased faster than those to non-EU trading partners. While unemployment, particularly in rural areas, approached a level well above that of most industrial countries, it reflects a problem typical in many fast developing transition economies. At about 8 percent, official unemployment was one percentage point lower than a year ago.

The external position has improved despite fast economic growth. The external current account deficit narrowed from 9.6 percent in 1999 to 6.8 percent in 2000. While the current account deficit remains large, it was mostly financed by non-debt-creating capital flows. The public sector debt-to-GDP ratio reached only about 10 percent, while reserves of Bank of Latvia are at a comfortable level covering roughly 3 months of imports.

The medium-term outlook is favorable. The recent credit expansion and further implementation of structural reforms should promote investments and generate an increase in productivity and robust growth over the medium term. Also, inflation is expected to remain low over the medium term.

#### Fiscal Policy

My authorities clearly understand that, under Latvia's fixed exchange rate regime, fiscal policy is the main line of defense against negative external shocks. In 2000, the general government fiscal deficit declined compared with the previous year, but remained above 3 percent of GDP. In addition to higher-than-projected spending, the fiscal deficit was adversely affected by tax-revenue-depressing factors, including low profit levels in 1999, high oil prices and difficulties in collecting petroleum excise taxes.

The 2001 general government budget fiscal deficit is projected to be 1.7 percent of GDP, the larger part of which stems from the Social Fund and the central government budget, while the local government budgets are broadly balanced. The fiscal deficit of the first quarter is significantly better than expected, which bodes well for achieving the annual deficit target.

The Latvian authorities consider the fiscal deficit for this year as a ceiling rather than a target. Should external developments make it necessary, a negative supplementary budget will be adopted during the second half of the year. The deficit will be further reduced in 2002 and over the medium term, thus creating the necessary preconditions for improvement of the external balance. In light of the strong GDP growth and further strengthening of the tax administration, tax revenues should comfortably match the program targets. In line with the fiscal goals, all transactions linked to privatization receipts (both revenues and spending) will be brought into the budget process. One of the

major tasks is to eliminate the structural deficit of the Social Fund by accelerating pension reform in the years to come.

Over the medium term, the government's policies aim at achieving two goals simultaneously. On the one hand, the Government has to maintain a broadly balanced fiscal position over the medium-term, but, on the other hand, the authorities have to accommodate substantial fiscal costs related to accession to the EU and NATO. To meet these goals, the authorities are improving the way they prioritize and manage public spending. Strengthening the medium-term fiscal framework, with the assistance of the World Bank under the public sector adjustment loan (PSAL), will help assess and manage difficult trade-offs between fiscal discipline and extra spending. In this context, the Fund's assessment of Latvia's compliance with the fiscal transparency module of the ROSC is also important.

#### Exchange Rate and Monetary Policies

Latvia has had a conventional exchange rate peg to the SDR since 1994. The composition of Latvia's foreign trade by settlement currencies closely resembles the composition of the SDR basket. This regime has been tested by severe shocks and it has successfully passed the test. Moreover, the peg has served Latvia well in bringing down inflation and moderating bilateral exchange rate fluctuations. Also, Bank of Latvia has employed and developed the full set of indirect, market-based monetary policy instruments that are used by the European Central Bank, and is fine-tuning the use of these instruments. The exchange rate peg continues to be appropriate, as evidenced by various indicators of Latvia's external competitiveness. As long as Latvia is well served by its exchange rate regime, there appears to be little reason to change it, and the authorities intend to shift to a euro peg at the time of Latvia's accession to the EU.

In December 2000, Bank of Latvia lowered the reserve requirements for credit institutions in Latvia by one percentage point to 6 percent. This cut will not only ease profit pressures on banks, but also bring reserve requirements more in line with those in the EU. Moreover, Bank of Latvia will gradually reduce the proportion of cash to be used for the purposes of complying with the reserve requirements, and will eventually abolish the use of cash for this purpose.

Healthy credit growth last year is a good evidence of a strengthened financial system. For instance, loans with a maturity of over one year increased by more than 40 percent, albeit from a very low level. The relatively strong increase in bank lending was not accompanied by deterioration of the quality of credit portfolios. On the contrary, at the end of 2000, the share of non-performing loans in total loans for the whole banking sector was only

5 percent, down from 6 percent in 1999. The commercial banks' risk management system and use of collateral appear to be appropriate.

In May 2000, Bank of Latvia, for the first time, auctioned foreign exchange swaps with a maturity of two years to foster long-term lending in lats by commercial banks. The swaps have contributed to the broader availability of long-term credits in lats, and the private sector is now ready to undertake this role. Therefore, Bank of Latvia has reduced the volume of monthly auctions, and will decide on a date for their full elimination by the time of the first review under the program.

### Structural Reforms and Financial Sector Policies

Pension reform remains a centerpiece of the structural reform agenda. The authorities intend to further raise the retirement age up to 65 years over the medium term, while, in the short term, current incentives for early retirement will be eliminated. Contributions to the second, fully funded, pillar will begin soon, on July 1, 2001. Eventually, this pillar will promote savings and capital market development. After an initial two year period under the Treasury, pension assets will be managed by private fund managers.

The restructuring of the Latvian banking sector has been completed. The industry is almost entirely in private hands, while foreign institutions own around 70 percent of total stock capital. Banking supervision is well advanced, and among the strictest in Central and Eastern Europe. Latvia is close to full compliance with the Basle Core Principles for Effective Banking Supervision and the relevant EU Directives. The transition to the new unified financial sector supervisory agency is being implemented in accordance with the schedule and will start operating on July 1, 2001. The Latvian authorities welcome the ongoing FSAP work which will be completed later this year.

Privatization of small- and medium-sized companies, which was launched in 1991, has been successfully completed. Also, the authorities are moving firmly to complete the transparent privatization of remaining large public enterprises. In December 2000, the Government passed privatization rules for the Latvian Shipping Company (LASCO), with a view to sell the majority interest (68 percent) of LASCO to private investors in May 2001. As of April 4, two firms have submitted initial tenders regarding LASCO to the Latvian Privatization Agency. The procedure for the privatization was thoroughly monitored by Transparency International. The Latvian Privatization Agency is also conducting negotiations with private co-owners of Lattelekom (telecommunications), with the help of foreign advisors, to advance the privatization process. Privatization of this company highly depends on the outcome of the above negotiations. It is also expected to sell a significant part of the public shares of Ventspils Nafta (oil company) by the end of 2001.

The Latvian authorities welcome the publication of the staff report for the Latvian request for a Stand-By Arrangement and the Letter of Intent, including the Memorandum of Economic Policies. They also initiated the publication of the main findings and recommendations of the fiscal ROSC in the staff report.

Mr. Mori submitted the following statement:

Latvia experienced in 2000 a significant improvement in its economic performance. Real GDP growth accelerated to 6.6 percent, and was broad-based, even in adverse circumstances such as higher oil prices and a depreciated euro. In this respect, developments in the external position were also notable, as the current account deficit narrowed to 6.8 percent of GDP, and its financing through FDI inflows rose to 82 percent. Latvia benefited from the economic strengthening in EU countries, which absorbed two-thirds of its exports, and this share is increasing. With higher growth, one could expect a much better fiscal outcome, though part of the weaker performance could be attributed to some tax-revenue-depressing factors.

In a short- and medium-term perspective, policy concerns in Latvia will be directed towards its objective to achieve EU accession. In fact, the accession has become one of the key driving forces behind the country's adjustment and reform efforts, as pointed out by Mr. Lehmuusaari. We are pleased to note the progress Latvia has achieved so far. In the process, fiscal policy is an important element as it will be essential not only to preserve the exchange rate arrangement but also to accommodate the burden to comply with the requirements for EU accession. Further efforts in the fiscal area are required, as indicated in the report, to restore a much tighter consolidation path, and to ensure the public sector's medium-term viability. Recent data have shown that the outcome was better than projected, indicating the authorities' commitment to the needed policies.

Another policy objective seems to be to reduce the volatility in GDP growth as observed recently in Latvia. In the case of a small open economy such as Latvia with a pegged exchange rate regime, this objective is more difficult to be achieved because monetary policy tends to be less effective. Fiscal policy can help to contain domestic demand and address concerns related to the external current account deficit, but fiscal policy alone cannot avoid large growth fluctuations. In this respect, developments in the credit market need also to be closely monitored. There could even be a better fiscal outcome but deterioration in the external current account may occur if credit expansion is not appropriately checked.

The strong growth rate of broad money and credit may reflect "both the deepening of financial markets and increased confidence in the banking system and the economy more generally," as noted by staff, but this process

tends to be normally more gradual. In any event, a precautionary approach is necessary to avoid excesses. We agree, therefore, with the policy recommendation to phase out foreign exchange swaps to control liquidity and avoid distortive incentives. We also agree that the authorities continue monitoring closely commercial banks, including cross-border transactions, and rigorously applying the existing prudential framework. Continuous strengthening of financial sector supervision is instrumental for limiting Latvia's vulnerability to shocks.

Prudent policies need to be pursued because of Latvia's prospects to continue its reliance on foreign savings for economic development, which may imply experiencing large current account deficits for some time. One could expect that a continued strengthening of Latvia's exports to the EU, together with a diversification in the export base resulting from broad-based FDI, may contribute to strengthen the external accounts. But, as noted, "the large investment needs in the years to come, coupled with a catch-up in private sector consumption will necessitate a leveling off in the improvement of the external current account deficit, as imports will continue to grow strongly and FDI-related profit remittances are expected to rise."

Like some other transition economies, the Latvian authorities face the challenge to reduce their high unemployment rate, which persists even in the context of a rapid economic recovery. One could expect that there would be a lag before a significant improvement occurs in employment in a process of recovery. One should also consider that the recovery may be taking place basically in sectors which are less labor intensive. Staff indicates skill mismatches and lack of geographic mobility, rather than labor policy rigidities, for the persistently high unemployment in Latvia. Obstacles to employment observed in other economies are absent to the extent that "employers have considerable latitude regarding hiring, firing and work conditions, minimum wages are fairly low, and unemployment insurance is not overly generous." Also, the economy as a whole has proven to be quite flexible, with sizeable reallocations of labor from declining to expanding sectors.

The problem of unemployment is complex, and may seem to require a comprehensive and more innovative solution. In general terms, this means "policies aimed at growth and job creation, supplemented by an adequate and well-targeted social safety net and selective well-designed active labor market policies." The specifics to attain the desirable result are more difficult to design given the characteristics of the transition process in which countries are experiencing radical changes in institutional and productive structure, including reorientation of trade towards western markets, not necessarily conducive to increase employment. In addition, in the process, there will be continued pressures exacerbating unemployment because of the privatization process and restructuring on both the macroeconomic and enterprise levels.

We support the proposed decision.

Mr. Santos submitted the following statement:

We would like to thank staff for a very good report and Mr. Lehmuussäari for his informative preliminary statement. We have very mixed feelings about the request for a Stand-By Arrangement that is before us. Indeed, performance under the previous arrangement was not good, as fiscal execution was way off-target throughout most of last year and implementation of reform policies was mixed at best. Hence, the failure to complete the second review under the previous arrangement, which was scheduled for late last year and would have been based on the observance of end-September performance criteria, came as no surprise. Since performance in the last quarter was equally poor, as the quantitative performance criteria on the fiscal deficit was missed by a very wide margin and both structural benchmarks were breached, we do not quite understand the decision to move to a successor arrangement immediately after the expiration of the previous one. We acknowledge that the authorities' policy intentions for this year are on the right track and particularly that the 2001 budget is in line with what staff believes are Latvia's needs. Still, we would have preferred to have hard evidence that policy performance has improved and hence would have seen merit in a strategy demanding the reestablishment of a good track record of policy implementation before jumping to a new arrangement. We understand that this is a precautionary arrangement and that Latvia has not drawn on Fund resources in past arrangements. However, we believe that should not lead to a relaxation in our standards, and the Fund's seal of approval should not be granted in these circumstances.

The report shows that despite the poor policy performance, economic developments last year were very positive with a pick-up in economic growth, sustained low inflation and a narrowing in the external current account deficit. While this is all true it is equally clear that the contribution of policy performance to that positive state of affairs was not substantial. Instead, low inflation has benefited from a strong appreciation of the real effective exchange rate over the past few years and economic growth and the narrowing of the external imbalance benefited from the buoyant external environment in the EU, which allowed a strong pick-up in export growth to the region. It is not likely that both factors will continue to play such a supporting role in the near future, as the potential for further appreciation is now minimal, if any, and the growth outlook in the EU has been substantially downgraded. Hence, chances are that, unlike in the recent past, any future fiscal slippages will come at a price, namely a revival in inflationary tensions and a deterioration of the external accounts.

For all this, while we share staff's optimism regarding medium-term prospects, over the short term we feel that a sound policy performance will be

determinant for the consolidation of the positive developments of the recent past. Given the exchange rate arrangement in place, the burden of the adjustment will fall squarely on fiscal policy, as is clearly acknowledged in the staff report.

Having said that, let me just make a few specific comments:

First, on the external sector, we are less sanguine than staff about the short-term prospects at least for a couple of reasons: first the full effect of the appreciation of the real effective exchange rate may have not been felt yet as the effect of exchange rate movements affect external accounts only with a lag. Moreover, it is not clear that an unwinding of the past depreciation of the Euro is taking place. Hence, the lat could stay at the current highly appreciated level in the near future. Second, much of the good performance reflects a buoyant EU economy which is expected to change, as we mentioned above.

On a related matter, we would see some merit in moving to a peg that better reflects the trading partners of Latvia in order to avoid the strong appreciations of the past brought about by the peg to the SDR. In Lithuania the peg is to move from the dollar to the euro and we feel that Latvia would also benefit in moving in a similar direction with a view to moving smoothly toward economic integration with the Euro area.

Second, on fiscal policy, we are somewhat disappointed that the program for 2001 is much less ambitious than the projections implicit in the previous arrangement, thus effectively accommodating last year's slippage. As we mentioned at the beginning, if the external environment is not as supportive fiscal policy may well squarely bear the burden of adjustment and reducing macro imbalances. Hence a strong performance in this area is crucial, and we are glad about the authorities' pledge to tighten further the fiscal stance if external developments prove adverse.

In addition to a reduction in the deficit, we believe that it is important to reduce the size of government. At about 40 percent of GDP, revenues and public expenditures have reached a level too high, close to those prevailing in EU member countries. Since public spending is normally considered as a superior good, Latvia, where per capita income is still way below EU levels, should have revenue and expenditure-to-GDP ratios substantially below EU levels. Hence, as the report refers, the focus of the adjustment should be placed on expenditure reductions that allow a cut in the relatively high tax rates. Reducing the size of government and tax cuts have been priorities of fiscal adjustment in the EU and consequently Latvia should follow this trend in order to ensure the medium-term competitiveness of its economy.

Third, on monetary policy, we agree with the proposed course of action but we would like to express a word of caution. The high growth in reserve and broad money aggregates programmed for this year is predicated on the continuation of financial deepening and a consequent increase in the money multiplier and money demand. While these are sensible assumptions, these are variables difficult to predict with precision in an economy going through a process of monetization. Hence, caution is in order and the authorities should follow monetary developments closely and react promptly to any signs of a deviation from the assumed pace of increase in intermediation. To the extent that money demand and the money multiplier do not grow according to projections, then the programmed money targets could entail an easing in the monetary stance that could contribute to put pressure on reserves, an area where the margin of maneuver is not substantial, and in time fuel inflation, particularly if the strong pace of appreciation subsides and stops supporting the persistence of low inflation.

Finally a more medium-term point. We believe that steadfast progress on structural reforms is important to improve the trade-off between growth and the current account deficit. After EU accession and, at a later stage, the locking of parities with the euro, good policy performance in these areas will be at a premium, as they will be key to improving economic efficiency, to getting a competitive edge vis-à-vis other EU members and hence to helping close the income gaps. We agree with staff recommendations in this area and particularly with the focus on policies geared to expedite privatization, improve the business climate and particularly attract FDI, in view of its key role in financing the external current account deficit.

Extending his remarks, Mr. Lehmuusaari stressed the importance of the timing of the Fund-supported program. While this was a precautionary program, which meant that the funds were not strictly needed, the policy guidance and the discipline that the Fund-supported programs provided were highly valuable in a country with a relatively short political cycle—with new governments elected approximately every eight months. Fund-supported programs played an important role in guaranteeing continued discipline in economic policies despite the frequent changes in government, and they also provided an anchor to policymakers in difficult times. Such political implications should be taken into account in the assessment of the need for a program and in the decision on the timing of the program.

On the track record, Mr. Lehmuusaari explained that the previous program had gone off track mainly as a result of budgetary problems. However, such problems had only been present in the year 2000, as a result of a number of developments spelled out in the staff report. Latvia had been one of the best performing accession countries in terms of general government finances in the period from 1997 to 1999, with an average public deficit of 1.7 percentage points. In addition to this, the fact that 12 out of 16 structural targets had been met in the 2000 program should also be taken into account in the assessment of the authorities' track record.



Mr. Maino made the following statement:

The strong performance of the economy and the stable macroeconomic environment clearly provide the basis for durable, noninflationary growth, and for the completion of a smooth convergence with the European Union by 2003. While external developments have recently been favorable, sound fiscal and monetary policies, together with the progress made in structural reform are the main causes for such a successful performance. An effective banking system regulation and supervision allowed the economy to withstand the spillover effects of the Russian crisis. The additional restructuring and privatization of banks triggered by the crisis further increased the system's resilience to negative external shocks. Currently, the system's risk-weighted capital ratio is above Basel minimums, and the supervision system is unified.

We encourage the authorities to persevere in their efforts to provide an environment conducive to investment through the consolidation of a favorable macroeconomic framework. We agree with the staff's appraisal and with the views expressed in other Directors' preliminary statements, especially on the strengthened financial system and monetary policy operations. In this area, we concur with the staff's support for the use of open market operations instead of foreign exchange swaps as the main mechanism to curtail the growth of NDA.

On fiscal policy, the nonobservance of fiscal performance criteria under the previous SBA hinders the achievement of a balanced budget in 2002, which is a necessary condition to consolidate the reform process into sustained and robust economic growth rates. A countercyclical behavior of fiscal expenditures would be needed in this phase of the economic cycle to build up a buffer that should allow the authorities to counteract the negative effects of an economic downturn in Latvia or in the EU, given that it will be more difficult to reduce expenditures once an external shock has negatively affected economic stability and reduced public revenue. Perhaps the staff could comment on this matter. An expenditure cap would also contribute to ameliorate the pressure on nontradable prices and the appreciation of the lats against the euro. We concur with Mr. Santos's view that reducing the size of government, while continuing to strengthen property rights and to expand the market economy, is a priority at the current stage of the accession process and an essential element of the transformation process. Consequently, we encourage the government to reinforce the privatization process and to articulate the pension reform in line with the targets envisaged in last year's program. This would represent a useful step toward the elimination of the structural deficit of the social fund. We would welcome the staff's comments on the prospects for such a reform.

As Mr. Lehmussaari has pointed out, the authorities have made progress in structural reform, which is the second pillar of the reform process.

Privatizations in the banking sector will be crucial to promote savings and the development of the capital market. The authorities are firmly committed to complete the privatizations that are already underway. We welcome the announcement that the shipping and telecommunication companies will soon be privatized. We concur with the staff's emphasis on the relevance of structural reform as a vital building block to achieve durable and sustainable growth and to attract foreign direct investment.

We support the authorities' request for a new SBA, with the set of quantitative performance criteria and structural benchmarks specified in Tables 1 and 2 of the second attachment to the staff report. The Fund-supported program will improve confidence on the achievability of the stabilization needed to complete the accession negotiations with the European Union.

Mr. Mozhin made the following statement:

Latvia has demonstrated quite impressive economic performance over the last year, and the Latvian economy has fully recovered from the slowdown in 1999. GDP growth has resumed and reached 6.6 percent in 2000, driven by a strong export performance and private investment. Inflation was low and mostly reflected the impact of administrative and energy prices increase. External position has strengthened as a result of improvements in the current account and sustainable FDI inflows allowing to contain debt indicators at a comfortable level. Despite the appreciation of the lats, external competitiveness remains sufficiently strong. Under these circumstances, the economic prospects have become more favorable than it was envisaged under the previous program.

Unfortunately, fiscal performance has suffered from policy slippages that occurred in the second half of 2000 and that became a reason that prevented the completion of the previous Stand-By Arrangement. Slippages in the fiscal area are highly regrettable, especially, given that the fiscal policy remains crucial under the conditions of high external current account deficit. Thus, further fiscal consolidation remains a key objective for the authorities, and I welcome the emphasis which is given to the fiscal policy in the requested precautionary SBA. I would urge the authorities to stay committed to the envisaged fiscal targets and to be ready for further tightening should external or revenue developments deteriorate.

It looks like much still needs to be done on both revenue and expenditure sides. On the one hand, a freeze in civil servant wages during this year together with civil service reform planned for 2002, restraint in non-priority current spending and moderate pension increase in line with the inflation rate will help to bring expenditure position to a more sustainable level. On the other hand, efforts to broaden revenue base through improving

tax and customs administration, eliminating tax exemptions and addressing other tax loopholes, will enhance fiscal position and provide room to reduce Latvia's relatively high tax burden.

I would like to express my satisfaction with the authorities' decision to publish the main findings and recommendations of the fiscal module of ROSC along with the staff report and believe that it will be a good contribution to improving fiscal transparency.

Monetary policy conducted by the Latvian authorities have been broadly satisfactory. And the authorities' decision to reduce their reliance on foreign exchange swaps for controlling liquidity in the banking system is very welcome. I agree with the staff that the authorities should rely more on open market operations for liquidity management, and steps to develop financial instruments in the disposal of the Bank of Latvia, instead of foreign exchange swaps, are crucial.

The exchange rate peg is a cornerstone in stabilization policies implemented by the authorities. Under this regime, market confidence continues to be strong and there is no evidence of significant pressure on the exchange rate. I agree that the peg has operated well so far and remains appropriate in the current external environment. However, the successful performance under the peg should be underpinned by sufficiently tight macroeconomic policies and close monitoring of competitiveness indicators.

Progress in the area of the financial sector soundness deserves to be mentioned. Key indicators of the financial sector stability have improved and financial sector regulation have been strengthened. Participation of foreign investors in the Latvia's banking sector have become more pronounced which reflects increased confidence and enhanced prudential framework. The authorities should continue implementing measures to bring their prudential regulation fully in line with best international practices. They also should continue monitoring closely developments in the banking sector, including issue related to large inflows of deposits from non-residents.

Some commendable progress has been already made on the structural reform front, although delays in some important areas occurred, and privatization of large enterprises has lagged behind the schedule. The authorities have undertaken decisive steps to bring the structural reform agenda back on track, and the privatization process has been restarted in a transparent manner. However, the situation in the energy sector raises concerns in the light of the recent Parliament decision to prohibit the privatization of Latvenergo. I believe that energy sector liberalization is very important.

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

Mr. Hagan made the following statement:

The benefits from earlier reform efforts have allowed the economy to quickly recover and return to the strong growth path that it will need to follow in order to succeed in the EU accession process. The authorities should continue their efforts to ensure that policies maximize the opportunities to reach annual growth rates on the order of 6 percent over the next five years. While the achievement of such an impressive rate of growth will be dependent on the existence of a favorable external situation, the authorities need to establish the domestic basis for growth. I agree with the staff's appraisal, and I expect, like Mr. Lehmussaari, a continued strong performance of the economy.

The authorities and the staff rightly place fiscal policy at the center of the new SBA. The exchange rate regime clearly places the emphasis on fiscal policy to drive macroeconomic policy. Box 2 in the staff report captures the essential difficulties and medium-term challenges posed by the current fiscal position. Recent slippages in fiscal policy, which have resulted in the failure to meet certain criteria under the previous SBA, are of great concern and should not be taken lightly. The unexpected off-budget expenditures are particular worrying, as they give the impression that the sound conduct of economic policy is less firmly entrenched than what the track records of the late 1990s would suggest. We urge the authorities to adhere to the current program. The main burden of the adjustment will fall on the expenditure side. It is hoped that an improved prioritization of expenditures and some efficiency gains will allow the negative effects of the fall in total spending to be less acutely felt. I endorse the proposal to ensure that privatization receipts are brought within the budget framework. I also support the efforts to increase fiscal transparency. In this regard, I welcome the publication of the fiscal ROSC's results and of the staff report.

The decline in the current account deficit in 2000 is particularly encouraging. The projected evolution of the current account deficit under the program seems to be manageable, particularly taking into account that the underlying assumptions on FDI are fairly conservative. The improvement in export performance—despite the appreciation of the lats—and the continued strength of FDI are particularly welcome. The continued increase in exports to the EU, and the wider geographical reach of exports should improve the economy's resilience to negative shocks. However, further sectoral diversification of exports would also be desirable. In this regard, we share the staff's concern on the high percentage of timber in the total exports.

On structural policy, the steps taken by the authorities in the process of privatization are welcome, with a particular emphasis on the efforts to increase the transparency of the process. Perhaps even more important at this stage are the efforts to improve the enabling environment for the private sector. Such improvements should not only be geared to attract FDI, but also to encourage domestic private sector investment.

With these comments, we support the proposed decision.

Mr. Repanšek made the following statement:

Macroeconomic developments in Latvia are generally positive. The revival of broad-based GDP growth is an excellent achievement. So is the buoyant export growth, despite appreciation of the lats. The inflation rate is commendably low and we agree with the staff that monetary and exchange rate should remain unchanged. A faster-than-projected drop in the current account deficit, financed by a sizable FDI inflow, is another positive element. This also enables external indebtedness to remain modest. It is indeed clear that Latvia has no need to purchase funds under the Stand-By Arrangement. However, we agree that there is a rationale for the requested Stand-By. We cite three reasons.

First, fiscal adjustment is lagging behind. Reduction of the current account and fiscal deficit has been cornerstone of Latvia's macroeconomic stabilization, and progress has been made. However, cause for concern remains. While the current account deficit is falling faster than projected, it is still 7 percent of GDP. The fiscal deficit is half that at 3.25 percent of GDP, but the pace of its reduction has been much slower than projected. The staff has identified a number of reasons for that. Some of them, like depressed 1999 profit levels, were one-time events. Others, including an underdeveloped tax collection system and unplanned spending out of privatization receipts, call for corrective measures. The proposed Stand-By Arrangement would back up the authorities in implementing them.

Second, medium-term fiscal challenges may endanger the fiscal consolidation. If the 2001 budget is implemented as planned, Latvia's expenditure-to-GDP ratio will shrink by 5 percentage points in the short period of two years. There remains little room for further adjustment, but a sizable further adjustment is still needed. An unavoidable increase of military expenditures by 1 percentage point of GDP by 2003 and costs related to compliance with the *acquis communautaire* of around 4 percent of GDP per year would bring the expenditure-to-GDP ratio back to 44 percent. Simultaneously, authorities plan to lower tax rates further. The authorities must successfully implement the proposed program if Latvia is to continue on the trend of fiscal adjustment that will lead to the medium-term target of a balanced budget.

Third, the exchange rate peg limits the choice of instruments available to the authorities. Latvia's labor market has gone through remarkable adjustments. However it is far from being flexible enough to help the economy to neutralize the possible shocks to which this highly opened and small economy is exposed. Given these limits, adjustments in fiscal sector are crucial for Latvia's macroeconomic stability. The authorities' program is appropriately focused on fiscal adjustment. Supported by a Stand-By it has a better chance to succeed.

For the reasons I have cited, we support the proposal for a Stand-By Arrangement and find the authorities' intention not to purchase funds appropriate.

Let me add a comment on the labor market. As in other emerging economies, in Latvia we may not expect too much from the labor markets. In the real world, they are not as flexible as economic theory would have us believe. We thank the staff for the information in Box 3 and encourage them to look further into the problem of high unemployment. Latvia is only one among several countries where real life has been disproving the idea of increased mobility of the labor force as the ultimate solution for high regional unemployment. The fact that reallocation of labor from declining to expanding sectors is only sporadically taking place in the countryside is only one of the questions calling for further research and alternative solutions.

I wish the Latvian authorities success in implementation of their program.

Mr. Cho made the following statement:

Latvia has been a remarkable success story of transition from a socialist to a market-oriented economy. Since joining the Fund in 1992, Latvia has been under a series of Fund-supported programs, taking full advantage of the benefits of Fund membership. Since 1996, the economy has constantly been under a SBA, and it has benefited from more than twenty technical assistances. Under these programs, the economy has become truly open, with a high trade-to-GDP ratio, and a level of net foreign assets on the order of 50 percent of GDP—although external debt is slightly larger. The country's determination to exploit its Fund membership to the maximum indicates the authorities' strong ownership and commitment to reforms. I believe this provides sufficient reason to support the country's fourth SBA. As for the contents of the program, I agree with the thrust of the staff report.

First, there is no doubt that fiscal adjustment is crucial to ensure the sustainable growth of the economy. This is not only because fiscal policies are the only macroeconomic tool available to the authorities after the monetary tool is assigned to accommodate the hard peg of the exchange, but also

because the fiscal deficit has been the major source of the country's saving investment gap, which has led to an increase in its external liabilities. Restraining the fiscal deficit is even more urgent to limit the crowding-out effect on private investment. The sensitivity analysis provided in Table 10 in the staff report shows that fiscal consolidation is the crucial factor for the medium term evolution of external debt, ahead of external shocks in the export sector. Even so, the difficulties to reduce expenditures will be considerable, given the expenditures required to meet the preconditions for accession to the EU and NATO. Against this background, the country has little choice but to adopt the approaches suggested in the staff report. While the authorities will need to establish priorities on the expenditure side, a broadening of the tax base, a limitation of tax exemptions, and improved tax administration will be required on the revenue side. In this regard, it is encouraging to note that the authorities have already moved in this direction by committing to advance the initiatives stated in the memorandum of economic policies.

Second, it is also encouraging to see that the authorities have agreed to curtail the use of foreign exchange swaps in their conduct of monetary policy. While the swaps might have been a useful tool to limit the growth of liquidity in the financial system and to secure foreign exchange reserves at the initial stages of transition, they raise a moral hazard issue on the part of the financial institution involved, as the risk is mostly borne by the authorities. I would like to ask the staff to explain why the outright elimination of the swap option is not included in the program in the hope of a speedier phasing out.

Finally, I agree with the staff that the country's unemployment rate has not fallen as quickly as the economy has grown. Notwithstanding the persistently high level of unemployment, wage increases have been considerable. The Bank staff might be better placed than the Fund staff to provide advice in that regard. Perhaps the staff representative from the Bank could comment on the Bank's plans to cooperate with the authorities in this area.

With these remarks I wish the authorities the best in their endeavors.

Mr. Yakusha made the following statement:

The authorities have made good progress in the transition toward a market economy since the last Board discussion, with substantial amounts of foreign investment flowing into the country. We encourage the authorities to press ahead with the remaining items in the reform agenda on institutional building, as these should enable the country to achieve the economic and political goal of joining the EU, conditional on the strengthening of civil rights. Therefore, I support the proposed precautionary arrangement and urge

the authorities to implement the program in a more consistent manner than in the previous precautionary arrangement, when important targets were missed.

I agree with the staff's assessment on the macroeconomic environment, which is remarkably stable. However, the threat of external shocks has not fully remitted. The account deficit remains relatively high, particularly when the envisaged accession-related rise in imports is taken into account. The deficit may be reflecting the slow fiscal adjustment or the increased exposure to EU competitive pressures, as greater demands are placed on firms to compete in the EU markets. We welcome the authorities' commitment to reduce the fiscal deficit. We would like to send a strong message to the authorities on the importance not only of implementing fiscal adjustment, but also of the need to fight distortions in the tax system and in expenditure policies. In particular, extra-budgetary funds need to be eliminated. It would also be useful to discuss with the authorities the effects that regional developments, such as the recent introduction of tax incentives in Estonia and the elimination of the income tax, could have on investment and the general behavior of economic agents.

On the external sector, while I support the staff's assessment on the appropriateness of the exchange rate regime, I am concerned that the typical behavior of the banking system in economies with hard pegs could result in an insufficient development of the financial sector. While the likelihood that cautious banks will primarily invest abroad in foreign reputable securities may not threaten the economy's short-term stability, it could result in a failure to sufficiently develop the financial sector. In addition, we would like to question the staff's optimistic outlook on the economy's external position. While we agree that a net external debt-to-GDP ratio of 15 percent is not a major cause for concern, the fact that total external debt stands at 64 percent of GDP also needs to be taken into account. I am not sure whether sufficient provisions could be mobilized in the event of a shock, which means that the authorities should accumulate additional foreign exchange reserves. The current level of official reserves is low compared to other countries in the region with similar monetary regimes. We would also like to note that we are falling behind the trend of streamlined conditionality in this case. Therefore, the staff should make an effort not to overburden the program, particularly taking into account the authorities' recent achievements.

Mr. Siegenthaler made the following statement:

The macroeconomic performance of Latvia has been impressive over the past few years. The relatively quick recovery from the Russian crisis, compared to other Eastern European and CIS economies and despite strong economic linkages to Russia, is certainly a sign of the country's improved policy framework and strengthened financial system. Furthermore, according to the current WEO, among the ten EU accession candidates Latvia will enjoy



the highest growth rate while at the same time keeping one of the lowest inflation rates this year.

However, serious policy slippages in the fiscal area occurred under the previous Fund-supported program. These slippages have put at risk the numerous other achievements and it is highly regrettable that they have caused the program to go off-track. Not less disappointing were the major delays in the privatization schedule, due, for example, to the adoption of an energy law by the Parliament prohibiting the privatization of Latvenergo.

Given this recent program history, the new SBA rightly focuses on fiscal policy. Improved public finances are key for Latvia to continued robust growth and a sustainable external position. We believe that a precautionary Fund-supported program can serve as a useful fiscal anchor, particularly in a rather uncertain political environment. I also agree with the staff that the somewhat less ambitious targets—compared to the previous program—are justified given the improved external position and the financing needs for the EU accession. Overall, we believe that the Latvian authorities understand the importance of further fiscal consolidation and that there is a good ownership of the program. In this regard, we also welcome the cooperation of the Fund and the Bank in the area of expenditure prioritization. Just for my personal education, I would appreciate it if staff could elaborate a bit on how the complementarity of the Bank and Fund efforts will work in this area. Also, in view of our recent conditionality discussions, I would be interested to know whether there will be any overlapping conditionality under the Fund and Bank programs.

Concerning structural policy, Latvia has done a very good job in privatizing small and medium-sized enterprises in the past. With large-scale infrastructure enterprises, however, success has been much more limited. The recent major delays in this process are certainly worrying. Speeding up this process will be crucial, not least to create more FDI inflows. We therefore welcome that the large-scale privatization continues to be on the government's agenda. I was nevertheless a little surprised to note that privatization has been deleted from the conditionality under the program. Could staff please explain why the program does not include any respective benchmarks anymore? I would be particularly interested to know whether the authorities insisted on excluding them or whether it was the staff who did not insist on including them. According to the Memorandum of Economic Policies, the authorities seem to envisage a number of projects in this regard, which could have served as benchmarks. The authorities also agreed that Transparency International will be monitoring the privatization process of the Latvian Shipping Company. I hope that this commendable move will help to shed some light on the allegations of corruption that have been voiced in this regard.

Finally, on program risks, I think that the unstable political situation due to the frequent changes of coalition governments might be the single biggest risk factor to the program. The victory of the Social Democratic Workers' Party in the March local elections has hardly helped in this regard. I was also quite astonished by some recently published results of a public survey saying that about 90 percent of the Latvian population did not trust the government and its agencies. This is certainly a dire indicator of considerable public mistrust in the state institutions, which the authorities would be well advised to try to correct. Nevertheless, we believe that the risks to the proposed program are moderate, particularly in view of the fact that the program is thought to be precautionary and that the access is very limited, equivalent to only 16 percent of quota.

With these remarks we support the precautionary SBA and wish the authorities good luck in their endeavors, particularly in demonstrating the population that their mistrust in the state institutions is unjustified.

Ms. Brukoff made the following statement:

The Latvian authorities continue to reap the benefits from consistent implementation of broadly appropriate macroeconomic policies, and we support the authorities' request for a SBA to underpin further efforts in this direction. Strong growth, low inflation, improving external balance, and large FDI inflows are the tangible signs of that success.

Like other speakers, we feel that slower progress on fiscal policy remains an area of concern. Specifically, we noted that the performance criterion in the previous SBA related to the fiscal deficit and indicative target on government revenues were missed.

While the export-led nature of last year's growth performance contributed to the lower-than-programmed revenue outcome, the continuation of tax benefits to special economic zones and free ports was also a factor. We support staff's continued emphasis on the importance of closing these tax loopholes and broadening the tax base, but would appreciate clarification on the reasons why this element was dropped as a structural benchmark in this new program.

We also support staff's emphasis on further rationalization and prioritization of expenditures, which will be critical in order for Latvia to manage the medium-term fiscal challenges ahead.

Like Mr. Hagan, we found expenditure decisions taken outside of the normal budgetary process to be a cause for concern. We would be interested in any additional information staff could provide about the process by which these expenditures were able to bypass normal procedures, how large these

expenditures were, and what controls have been instituted to prevent this from recurring.

Given these challenges, we agree with those who have mentioned that publication of the fiscal ROSC will be an important contribution to fiscal transparency.

Turning to monetary policy, we note that the authorities and staff support the continuation of the SDR peg. Could staff comment on any planning or preparation that the authorities will need to undertake in order to transition smoothly to the euro peg in conjunction with EU accession?

We are generally satisfied with the authorities' implementation of structural reforms, but have some questions about related conditionality going forward.

We are concerned to see that the structural benchmark related to public sector reform, only partially met under the previous program, has been dropped. We would like for staff to elaborate on the judgments underlying that decision—specifically why these reforms were not considered important or critical enough to the success of the program be retained—and the extent to which public sector reform will be covered by conditionality in any existing or upcoming World Bank operations.

We are also concerned about lack of progress on enactment of a telecommunications law. This was also a structural benchmark in the previous program but not implemented, and this benchmark has not been repeated in the new program. The staff report indicates that further action on this law is on hold pending the outcome of legal action related to Lattelekom. Could staff elaborate on the link between this legal action and the authorities' ability to move ahead with the telecoms law?

Mr. Schollmeier made the following statement:

Latvia has weathered the recession triggered by the Russian crisis in an impressive manner: The recent update by the staff reflects that macroeconomic developments in 2000 turned out to be much better than expected. In particular, growth performance has been impressive.

We are almost fully in line with staff's analysis and recommendations; we support the request for SBA. I will limit my remarks to three points and I have a brief question.

First, fiscal adjustment is the cornerstone of the new program, or—as Mr. Lehmuusaari mentioned in his focused preliminary statement—the main line of defense against external shocks. The fiscal adjustment of one-and-a-

half percentage point—compared to the previous year—will be demanding; however, it is important to break with the fiscal overruns under the previous SBA. Also, we welcome the commitment to further tighten fiscal policy, if suggested by external or revenue developments. The main adjustment burden is put on the expenditure side. However, based on the favorable growth perspectives, also revenue developments—together with administrative improvements and pension reforms—should help to meet the fiscal objectives. Still existing tax exemptions and tax holidays are of concern; they have to be tackled in line with EU regulations.

Secondly, on exchange rate policy, staff and the authorities share the view that the peg to the SDR has served Latvia well. It has been tested by severe shocks and has passed the test successfully. The trade-weighted real exchange rate appreciated by about 5 percent in 2000. Competitiveness has been maintained by moderate wage increases and continued gains in productivity. However, in the future both instruments might reach their limits, i.e., wage moderation might only be feasible up to a certain degree, also, the room for further productivity gains in the catch-up process following the transition to a market economy might shrink. Therefore, external competitiveness indicators have to be monitored carefully. Against this background, ways and means to move to an Euro peg before EU-accession should be explored. Needless to say that such a move has to be cautiously prepared accompanied by appropriate monetary and fiscal policies.

Thirdly, progress with regard to privatization has been mixed: There is substantial progress in the banking sector and in the area of small- and medium-sized companies. However, the real challenges still lie ahead when it comes to privatizing LASCO, Telekom, and, in particular, the energy sector. The authorities should not lose momentum in this regard. Foreign participation is important to transfer know-how, increase competitiveness and contribute to the financing of the current account deficit. Net foreign investment still is considerably below the pre-crisis level in 1997.

Before concluding, I have a brief question to staff on the issuance of government bonds in excess of immediate demand—as mentioned in paragraph 30. In our view, the related interest costs pose an additional burden on the budget and could run counter to the intended reduction of the budget deficit. Clarification is welcome.

The staff representative from the European II Department (Mr. Schiff), in response to Mr. Maino's question on the need for increased flexibility in fiscal policy, agreed that this was a crucial aspect of the program, which had led the staff to emphasize the need to improve budgeting and expenditure management processes. The staff and the authorities had agreed on a back-loaded distribution of expenditures in the current program to allow for further fiscal adjustment later in the year 2001 if this were required, although reducing spending would always be difficult.

Regarding Ms. Brukoff's question on the process for extra-budgetary spending, the staff representative informed that such expenditures had been funded with privatization revenue from the sale of the gas company. While these funds would normally have been transferred to the central government, a portion of the receipts had been spent on off-budget expenditures, resulting in a breach of the deficit target.

On the last question raised on the fiscal side, the staff representative explained that the rationale for the issuance of government bonds beyond the government's borrowing needs had been motivated by the authorities' will to develop the domestic capital market. The authorities were also increasing the maximum maturity of treasury bonds from three to five years, and there were prospects for the issuance of ten-year bonds. The authorities were aware of the fiscal cost implied and viewed such issues above their financing needs as a one-time transition effort to spearhead the development of the domestic capital market. For these reasons, the staff did not expect issues of bonds to be continually made above the government's financing needs.

Turning to monetary policy, the staff representative addressed the issue of the peg to the euro by stressing the need for a transparent process that would allow enough time for economic agents to take the necessary actions to adjust to the new exchange rate regime. This would allow, for example, the banking sector to adjust its open positions. The Bank of Latvia would also need to adjust its reserve management practices, as these would no longer reflect a peg to the SDR, but to the euro. While the authorities were aware of the need to do this, the process of adaptation had not yet started, as they did not expect to introduce the change in pegs for several years.

In response to the question on the lower money-to-GDP ratio in Latvia than in Estonia, the staff representative pointed to the possibility that this reflected earlier foreign participation in the banking system in Estonia, or the fact that confidence in the banking sector might have taken hold earlier in Estonia, or that the Estonian system was less acutely affected by the 1998 Russian crisis. While it was not possible for the staff representative to ascertain the specific causes for the different money-to-GDP ratios in Latvia and Estonia—as this would have required a review prior to the meeting of the specific circumstances in Estonia—a recent increase had been observed in the money-to-GDP ratio in Latvia.

Regarding the question on the phasing out of swaps, the staff representative made a distinction between short and longer-term swaps. Short-term swaps were only problematic when the outstanding stock became relatively large compared to the overall size of reserves. The fact that the program's design provided the authorities with a strong incentive to move away from swaps and toward open market operations led the staff to expect a decline in the stock of swaps over the duration of the program. As far as longer-term swaps were concerned, while the staff would have preferred to eliminate such swaps faster, an agreement had been reached with the authorities to gradually reduce the monthly auctions—starting in April 2001—with the aim of totally eliminating them over the duration of the program.

In response to a number of questions on structural reform, the staff representative observed that the staff's approach had been to streamline the areas of conditionality within

the program and to work with the Bank on those areas that fell within their area of expertise. This explained, for example, the absence of conditionality on privatization, even if the authorities' policies in this area were still described in the government's memorandum of economic policies. This area would be captured instead through the World Bank's PSAL operations. The Fund's role would also likely be complementary with regard to public sector issues, such as civil service reform, as this fell within the Bank's area of expertise, while other areas such as fiscal transparency and expenditure management traditionally lay in the Fund's area of expertise. In this case in particular, the benchmark on civil service reform had been dropped from the program conditionality because it had been largely fulfilled with the approval of a civil service law. The fact that the accompanying wage scale had already been approved by the cabinet meant that the only part of the reform that would still need to be monitored would be the implementation of regulations, which would be monitored in the context of the Bank's PSAL.

Regarding the delays in the approval of a new telecommunications law, the authorities were currently negotiating with the private owner of 49 percent of the telecommunications company a reduction in the period of validity of the company's monopoly rights, which was scheduled to last 15 years, ending in 2013. It would not be possible for the authorities to approve a law to regulate the provision of telecommunications services until such a fundamental issue had been resolved.

To conclude, the staff representative explained that while a benchmark on the approval of the law that would regulate tax free zones had not been included in the program, the staff considered the broadening of the tax base to be an important aspect of the program. The staff had obtained the commitment from the authorities that no additional tax exemptions would be introduced, which was an important step to broaden the tax base, taking into account that a large number of exemptions would expire shortly. The staff was confident that the law, which had been already submitted to parliament, would be approved regardless of its exclusion from the program conditionality, as the approval of the law was one of the requirements for EU accession.

The second staff representative from the European II Department (Mr. Mueller), in response to Mr. Maino's question on the schedule for pension reform, indicated that most of the steps required had already been taken by the authorities, as described in the 2000 Article IV staff report. The remaining issues for the coming years were the need to curtail early retirement, allowing working pensioners to collect their pensions while working, and raising the retirement age to 65 years from its considerably lower current level. The Bank would address these issues in the forthcoming PSAL which would be assessed by the Bank's Board in the third quarter of 2001. The Bank staff was currently negotiating with the authorities, among other issues, the indexation formula which would be an important element of pension reform. The Fund-supported program had focused on the first pillar of pension reform which was the curbing of early retirement. This had been included as a structural benchmark to be completed by end-June 2001. Regarding the second pillar of pension reform, the authorities were currently drafting the guidelines for asset management and other related procedures. These guidelines were expected to be operational by July 2001. Voluntary private pensions, which would be the third pillar of the reform, would take a

longer time to develop, considering that the volume of private pension funds was still low, despite the recent creation of new funds by the major companies in the sector.

The staff representative from the World Bank (Mr. Peters), in response to a question on electricity privatization, explained that the Bank was processing the second in a series of adjustment loans which focused on public sector reform issues described in the staff report. Several of these issues referred to privatization. The Bank had been concerned with the approval of a law that removed the privatization of the electricity company from the authorities' near-term plans. The Bank staff had worked with the authorities under the framework provided by the adjustment loans to introduce measures to improve the competitive nature of the environment in which the electricity company operated—primarily through energy market deregulation and to increase transparency in the operations of the electricity company through measures, such as the publication of electricity tariffs, which should help to reduce public opposition to privatization, as it would increase public awareness of the efficiency gains achieved in electricity distribution. The Bank staff was also planning to work with the authorities to restructure the electricity company in line with EU guidelines, in particular through the separation of the transmission, distribution and generation activities of the company.

The Fund and the Bank staff agreed on the need to control public spending, the staff representative continued. The Bank was involved in the public sector reform program, which was supported by an adjustment loan and by technical assistance to improve expenditure management systems and mechanisms, especially in the line ministries. This improved control over public spending should allow the authorities to prioritize expenditure according to their strategic plans. The Bank had contributed in the previous year to the FAD mission, in particular on ways to rationalize expenditures on health and education. Regarding the high unemployment level described in Box 3 of the staff report, this was a common issue in EU accession countries. The Bank had undertaken some work in Latvia on this issue in its poverty assessment and it was working on this issue in its cross-country work on EU accession countries. Any measures could be incorporated in the next phase of the adjustment loan.

Mr. Siegenthaler asked the staff representative from the Bank to provide further detail on the structure and timing of the privatization process which was part of the Bank's conditionality.

The staff representative from the World Bank (Mr. Peters) answered that a meeting had been recently held on this matter, and a mission was scheduled for the following week to agree with the authorities the details of the privatization process. The Bank staff hoped to present the program to their Board in late August or early September 2001. The Bank staff were also working with the Fund staff to ensure that some track record in fiscal adjustment could be achieved before going ahead with the PSAL, which explained why the Bank's work lagged slightly behind the Fund's program in the country. Privatization concerns over the level of corruption in the country had led the Bank to focus, in the first adjustment program, primarily on improving the transparency of the privatization process in the early stages of the plan. While it was regrettable that some of the larger privatizations had not taken place, the

improvements achieved—in conjunction with the Fund and the authorities—in the quality of the process should not be underestimated. International advisors had provided technical assistance to introduce adequate processes. The adjustment loans' conditionality required the authorities to prepare the three remaining large public enterprises—LASCO, Ventspils Nafta, and Lattlelekom—for privatization. More generally, the Bank was also working to improve the enabling environment for the private sector. While the work of the Bank on its adjustment operation was not as advanced as that of the Fund, considerable progress had thus far been made in the development of a roadmap through the various adjustment loans granted by the Bank.

Mr. Lehmuusaari expressed his reservations regarding the appropriateness of the Fund's recommendations in the area of privatization. While the outlook for the financial sector was positive, given the expected positive outcome of the recent FSAP, the suitability of the Fund's standard advice on privatization, in line with the Washington consensus on deregulation and liberalization, was not clear in this case, particularly in the light of the current discussions on streamlining conditionality. The concern had been raised in these discussions that the Fund should be cautious about the inclusion of privatization in the program's performance criteria, as the problems with the deregulation process in the Russian energy sector had illustrated. The Fund should consider this complex issue on a case-by-case basis, always taking into account country-specific circumstances. The advice to privatize would only be justified on the basis of calculations by the staff of the cost to the public budget of maintaining public companies that were making losses, or on the basis of major economic gains to be achieved as a result of privatization. These conditions were not always met. Furthermore, the fact that completing the privatization process could be difficult under certain circumstances had to be acknowledged, as the case of the European telecommunications companies illustrated. Nevertheless, these comments were of a general nature and should not be interpreted as meaning that no benefits could be obtained from privatization in this particular case.

Regarding the Fund's and the European Union's objectives in the country, Mr. Lehmuusaari observed that these were somewhat inconsistent. While the Fund was mainly concerned about achieving a stable macroeconomic framework in its negotiations with the authorities, the negotiations with the EU often resulted in increased spending in accession countries to achieve real convergence with the EU, which was incompatible with the Fund's short-term objective of macroeconomic stability. It was hoped that the discussions held at the Fund on this matter in recent months could lead to increased coordination between the Fund and the EU to address this issue.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the strengthening of economic performance in 2000. Economic growth, driven by private investment and buoyant export performance, was robust and broad-based. Inflation fell close to rates prevailing in the European Union (EU), and the external position improved. Directors commended the authorities for the generally appropriate macroeconomic policies pursued



during the last two years, and for the progress made toward completing the structural reform agenda, which had contributed to these favorable results. At the same time, Directors expressed concerns about the fiscal slippage in the second half of 2000, the slow progress with some reforms, and the persistence of high unemployment despite rapid economic growth. They strongly emphasized the importance of achieving program targets in 2001.

Directors generally considered that Latvia's vulnerability to external shocks has lessened. External competitiveness has been maintained. The external current account deficit has fallen substantially, and is mainly financed by rising foreign direct investment. External debt is moderate, and the financial sector and its regulatory framework have been significantly strengthened. Directors welcomed the authorities' commitment to continuing sound policies, which they saw as critical to preserving and building on accomplishments to date. They emphasized that, given the fixed exchange rate, an appropriate fiscal stance will be the key to reining in the still large external current account deficit and reinforcing Latvia's ability to withstand potential external shocks.

Directors recognized that the task of fiscal policy will be complicated by medium-term spending pressures associated with Latvia's planned accession to the EU and to NATO. They noted the authorities' interest in selectively reducing tax rates as much as possible, which they fully supported. Against this background, Directors saw measures to prioritize and durably reduce expenditures as crucial. In this context, Directors attached particular importance to implementation of the public sector reforms envisaged under the program, notably the measures to improve budgeting, expenditure policy and management, and fiscal transparency. Directors welcomed the authorities' intention to prevent further spending of privatization receipts outside of the budget. Regarding the revenue side of the budget, Directors encouraged the authorities to persevere in their efforts to improve tax and customs administration, and to contain the erosion of the tax base by curtailing the use of tax exemptions and holidays.

Regarding the quantitative goals of fiscal policy, Directors commended the authorities' intention to balance the budget over the medium term. They saw implementation of the 2001 budget as agreed, and adoption of a budget for 2002 with a fiscal deficit of no more than 1 percent of GDP, as important steps in this endeavor. They welcomed the authorities' commitment to tighten further the fiscal stance in 2001, if external or revenue developments prove adverse during the year.

Directors commended the reform of the pension system, which has placed the Social Fund on a firmer financial footing and set the stage for the introduction of the fully funded pension pillar. They welcomed the authorities' plans to eliminate the current incentives to retire early.

Directors viewed Latvia's exchange rate peg to the SDR as appropriate in the current external environment. They emphasized the need to monitor indicators of external competitiveness closely and to maintain prudent macroeconomic policies necessary to sustain the peg. Some Directors noted that Latvia would move to a euro peg when it joins the EU, for which timely preparation in due course would be necessary. Directors supported the Bank of Latvia's decisions to lower its reliance on short-term foreign exchange swaps in favor of open market operations in managing liquidity, and to phase out long-term foreign exchange swaps within a year.

Directors noted the strengthening of the banking system and commended the Bank of Latvia for having brought its banking supervision framework close to full compliance with the relevant international standards. They emphasized the importance of continued vigilance in enforcing this framework, monitoring the inflow of non-resident deposits, and ensuring the quality of the rapidly expanding claims on the private sector. Directors were satisfied that the transition to unified financial sector supervision was on track.

Directors welcomed the determination of the Latvian authorities to complete their structural reform agenda. They stressed that these reforms would be essential to sustain economic growth, prepare for EU accession, and reduce unemployment and Latvia's vulnerability to external shocks. Directors attached particular importance to the transparent and efficient privatization of the remaining large-scale state enterprises and to measures to improve governance and the business climate. They commended Latvia's liberal trade regime.

Directors noted the authorities' intention to treat the Stand-By Arrangement as precautionary. They also noted the value which the authorities place on continuation of their close policy dialogue with the Fund, especially during periods of political uncertainty.

The Executive Board took the following decision:

1. The government of the Republic of Latvia has requested a Stand-By Arrangement for a period of twenty months in an amount equivalent to SDR 33 million.
2. The Fund approves the Stand-By Arrangement set forth in EBS/01/44, Sup. 1 (4/30/01).

Decision No. 12472-(01/40), adopted  
April 20, 2001

#### **4. SRI LANKA—2001 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT**

The Executive Directors considered the staff report for the 2001 Article IV consultation with Sri Lanka and its request for a Stand-By Arrangement (EBS/01/41, 3/21/01; and Cor. 1, 4/13/01). They also had before them a background paper on recent economic developments in Sri Lanka (SM/01/93, 3/21/01).

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

The following information, which does not change the substance of the staff appraisal in EBS/01/41, has become available since the staff report was issued.

One prior action remained to be completed before the Board consideration of Sri Lanka's request for a Stand-By Arrangement. This relates to the administrative price increase for diesel and fuel oil, which was originally proposed to be implemented on March 25, 2001. In the event, the government decided to wait until the parliamentary discussions of the 2001 budget were completed. The final reading of the budget took place on April 11, 2001, and the price increase, together with an increase in kerosene prices, was put into effect on the evening of April 15, 2001 (after the Sri Lankan New Year festivities). The formal gazette and press coverage of the increase became available on the morning of April 16, 2001 (Colombo time). With this development, all prior actions have been completed.

The 2001 budget was passed on April 11, 2001, with no changes to the framework set out in the staff report.

In spite of the recent strengthening of the dollar against the euro and the yen, the Sri Lankan rupee has stabilized in the Rs 86–88 per dollar range since February 2001. In nominal effective terms, the rupee has depreciated 9.5 percent since March 2000. Staff estimates indicate that the real effective exchange rate for March 2001 was roughly unchanged from that of a year earlier.

In line with the staff's advice on the need to amend the foreign exchange regulations introduced following the float, the Central Bank of Sri Lanka reduced the 50 percent deposit requirement imposed on forward sales and purchases of foreign exchange to 25 percent on March 19, 2001. Limits on the daily foreign currency working balances of banks were also revised and relaxed on March 30, 2001. The limit is now set at 10 percent of capital and reserves, with the implication that the overall limit for the banking sector has now increased from US\$33 million to US\$46 million. In addition, the regulation which required public enterprises to channel all foreign

exchange transactions through the two state banks was removed on March 20, 2001.

After increasing to 16.5 percent in February 2001, the 12-month rate of inflation fell sharply to 13.25 percent in March 2001, as a result of declines in the prices of certain food items. The moderation in inflation was also helped by the stability of the rupee in February 2001, after the substantial depreciation since the latter half of 2000. The decline is broadly in line with program projections for the 12-month rate of inflation to decline to about 8 percent by the end of 2001.

Latest data indicate that the monetary program is on track. Preliminary information suggests that the March 2001 target for reserve money was observed (Rs106.3 billion, compared with target of Rs110.6 billion). Based on data through February, the indicative targets for end-March 2001 on net domestic assets of the central bank and net credit to government are also projected to be met with a comfortable margin. With the rupee stable and real interest rates increasing with the decline in inflation, the Central Bank of Sri Lanka (CBSL) reduced the repo and reverse repo rates by 0.5 percent to 18.5 percent and 21.5 percent, respectively, on April 3, 2001. The staff have advised against lowering rates further before fiscal consolidation is well under way and it is clear that inflation is under control.

On the external front, the trade balance has improved while official reserves are on target. A trade surplus of US\$15.2 million was reported in February 2001, largely because of low imports. Consumer imports declined by 24 percent (compared with February 2000), in part related to the exchange rate depreciation and the introduction on February 21, 2000 of a 40 percent import surcharge. Preliminary data suggest that net official reserves amounted to US\$744 million at the end of March 2001, which was US\$34 million above the target.

On financing from other sources, steady progress is being made. Out of US\$41 million expected from bilateral sources, about US\$20 million has already been disbursed by the Japanese government to support small and medium scale industries in Sri Lanka. Negotiations for the US\$200 million commercial loan are entering their final stage, with revised proposals having been submitted to the government. Meanwhile, efforts are continuing with the World Bank and Asian Development Bank to ensure the disbursement of the additional financing, as agreed.

Mr. Jayatissa submitted the following statement:

Maintaining a reasonable macroeconomic balance and making further progress in structural reforms became the challenging task in 2000 as a result of a sharp rise in oil prices and in security related expenditure and shortfall in

privatization proceeds due to unfavorable international market conditions. There was also some uncertainty, which affected investor sentiment in the run up to the elections. The Presidential election was held in December 1999 and the Parliamentary election in October 2000. At the Parliamentary election the People's Alliance returned to power for a second term with a mandate to continue with economic reforms. The highest priority will be to bring the 17 year-old conflict to an end. The authorities have repeatedly stated their commitment to a negotiated peace settlement, and the Government of Norway is assisting my authorities in finding a solution through diplomatic channels. The authorities are hopeful that this process will lead to a lasting solution to the conflict, although it is a difficult process. The authorities are determined to strengthen the ongoing structural reforms to accelerate high quality growth, and avoid a balance of payments crisis which had become an immediate challenge to the government over the past year.

Given its high trade dependence of about 70–75 percent of GDP, the benefited significantly from the recovery of world trade in 2000. Despite a deterioration of the terms of trade by 12 percent in 1999 and a further 3 percent in 2000, real GDP grew by 6 percent in 2000 reflecting high growth in export-related manufacturing activities, wholesale and retail trade, the banking sector, expansion of telecommunications, and a record output of tea and coconut and high growth in paddy. Despite the civil conflict, which was largely restricted to some parts of the north and east, the economy continued to grow, but it was below potential. The estimates by the Central Bank of Sri Lanka showed that its economic growth rate could have been 2–3 percentage points higher, if not for the conflict. Productivity in the tea sector has been growing steadily following the handing over of the management of major plantations to the private sector under a long-term lease, a few years ago. With improving prices the smallholders too came up with substantial output growth. However, the overall performance of the agriculture sector was relatively weak, although there has been a considerable improvement in the dissemination of agriculture market information and in the distribution and marketing network of agricultural products during the last few years.

The inflation rate, which was on a declining path from about 16 percent at end 1997 to 4 percent in 2000, started to pick up after mid-2000 owing to increases in administered prices of diesel (108 percent), kerosene (87 percent), furnace oil (106 percent), LP gas (57 percent), transport fares (32 percent) and electricity (32 percent). These price increases were implemented in several steps from February 2000, consequent to increased international oil prices and the depreciation of the exchange rate by 16 percent during the last 12 months. The latest increase in administrative prices was the implementation of the prior action on diesel and fuel oil prices in addition to an increase in the price of kerosene, with effect from midnight on April 15. The Colombo Consumers' Price Index reflected an annual inflation rate of 16.6 percent in February and 13.2 percent in March this year but a significant

deceleration of the rate of inflation is expected in the second half. The unemployment rate declined further to 7.7 percent in 2000, compared to 9.1 percent, a year ago. Inflation and high unemployment continue to be major issues in the management of the economy.

Official foreign reserves and the exchange rate came under increased pressure as a result of higher oil prices and military imports. Sri Lanka relies entirely on imports for its petroleum needs. The import bill on petroleum increased by US\$400 million in 2000, in addition to the cost of military imports of about US\$200 million. The current account deficit of the balance of payments rose from 4 percent of GDP in 1999 to 7 percent of GDP in 2000. Although there were higher capital inflows including short-term borrowing of US\$100 million, official reserves declined by US\$613 million in 2000. Realizing the emerging threat to the balance of payments, the government implemented several corrective measures early to address the problem, giving due consideration to what could possibly be implemented during a run-up to the elections.

There was a significant fiscal slippage in 2000 due to revenue shortfalls, higher military expenditures, increased interest payments and a long overdue wage increase granted late in the year. Given the difficult conditions, the government introduced measures to curtail other expenditures by instructing all ministries to reduce lower priority expenditures by 5 percent, slowing down the largely domestically financed investment projects while also raising taxes on tobacco and alcohol and the National Security Levy (by 1 percent to 6.5 percent). By the end of the year public investment was lower by 1.7 percent of GDP compared to the planned 8.2 percent of GDP. Although these measures were helpful to some extent, the year ended with an overall deficit of 9.8 percent, overshooting the original target for 2000 (and the deficit in 1999) by a little over 2 percent of GDP. The primary balance worsened by 2.5 percent of GDP compared with 1999. Due to the unfavorable domestic and international environment the planned privatization program (especially of Sri Lanka Telecom) had to be postponed, thereby raising domestic borrowing to over 8.5 percent of GDP compared with the original target of 3.5 percent of GDP, and 6.7 percent of GDP in 1999. This situation, together with the increased financing needs of public corporations—largely related to high oil prices—exerted pressure on domestic interest rates.

The government is firmly committed to contain the deficit as early as possible. The budget for 2001 accompanied a medium-term framework, targeting the overall deficit at 8.5 percent of GDP in 2001 and 5.5 percent by 2003. This was consistent with the policy statements issued by the President in the new “Vision 21” in November 1999, before the presidential election and the latest statements made after the November 2000 parliamentary election, which envisaged a reduction of the fiscal deficit to 3 percent by 2010. In the context of the 2001 budget, several revenue-raising

and expenditure-reducing measures were announced, and some were implemented before the budget was presented. The budget was approved on April 11. The budget contained both short-term economic stabilization measures as well as those which are necessary to correct some of the structural weaknesses in the fiscal area. These measures have been summarized in Box 3 of the staff report. They are expected to reduce the deficit by 3.4 percentage points of GDP from a projected fiscal deficit of 11.4 percent of GDP, in a baseline scenario without measures as stated in the Budget presentation.

One major fiscal problem was the inadequate revenue buoyancy in the tax system. The tax system still suffers from major weaknesses including administrative difficulties, despite the considerable simplifications and rationalizations that have been made in the recent past. The 2001 Budget contained measures to correct some of these weaknesses (e.g. extending the coverage of the Large Tax Payer Unit to include large GST taxpayers, harmonization of the tax and dual customs regimes for export processing zone firms and others. The FAD has agreed to provide Technical Assistance to address the weaknesses in the tax system and tax administration.

The expenditure-reducing measures mentioned in Box 3 are already in place. The government is well aware that room for maneuverability of economic policies has been seriously constrained by the high security expenditures, and it has resolved to reduce the total security expenditures to Rs.63 billion (4.4 percent of GDP) in 2001 from Rs.71 billion (5.6 percent of GDP) in 2000. Excluding public order and safety, such expenditure as a ratio of GDP is expected to decline to 3.3 percent in 2001 from 4.6 percent in 2000.

Monetary policy has been reasonably tight. In the context of a monetary targeting framework, the growth of reserve money has been tightly controlled through open market operations, with repo and reverse repo rates as the major signaling instruments. In the wake of increased public sector borrowing and the pressures on foreign reserves, the repo and reverse repo rates were increased in several steps since the beginning of 2000. The two rates reached 20 and 23 percent, respectively, in January 2001 from 9.25 and 13.48 percent at the beginning of 2000. There has been a continuous liquidity tightness in the market and the Central Bank reduced these two rates by 150 basis points recently, as it was of the view that money and exchange markets have gained stability to some extent.

The Central Bank is focusing on making further improvements in the conduct of policy in the context of a flexible exchange rate system with a view to adopting an inflation-targeting framework. Arrangements have been made to study the inflationary process and to undertake forecasting. The Bank is receiving assistance from the Swedish Central Bank in this regard.

The managed float within a band in force since 1977 came under threat with a considerable weakening of official foreign reserves. After several steps taken since mid-June 2000 in widening the band to 5 percent, the exchange rate was allowed to float on January 23, 2001. As the exchange rate had been continuously depreciating under the managed float since 1977 to reflect economic fundamentals, the typical overshooting after a float lasted only a few days and the market has now stabilized. The weighted rate against the U.S. dollar in the interbank market on April 18, 2001 was Rs 87.67 compared with Rs 73.74 a year ago.

The central bank was very concerned about a possible excessive overshooting of the exchange rate in a thin market when the float was announced with a relatively weak foreign reserve position. Therefore, with the announcement of the float, the Bank put in place, in consultation with commercial banks and forex dealers, several prudential measures as safeguards against excessive speculation to help maintain orderliness in the market. These measures consisted of penalty interest rates on exporters who do not settle their credits within 90 days and the requirement that these credits be settled out of their exports proceeds; limits on the net open position of commercial banks based on the share of foreign trade credits; instructions not to allow customers to settle their import bills before maturity; and imposing a 50 percent deposit requirement on forward contracts by importers. The key public enterprises were also instructed to hedge their large exchange contracts with advise from the state banks to prevent a disruption of the very thin domestic market. The authorities have stated that these were temporary measures, which would be relaxed as early as possible and the process for relaxing the measures have begun. Accordingly, on February 16, the settlement period for export credits was extended to 120 days. On March 19, the deposit margin on forward contracts was reduced to 25 percent. On March 30, the limits on banks open foreign currency position was increased from US\$33 million to US\$46 million for all banks, based on their capital instead of trade shares, while keeping the net open position at the previously determined level of US\$120 million. On March 20, the circular to state enterprises to deal with state banks was withdrawn while requiring key corporations to seek prior treasury approval for new credit from banks. The central bank is in regular consultation with the banks and the Foreign Exchange Dealers' association to review market developments and address any issues in an orderly and cooperative manner.

The decline in official reserves has been arrested and the maturing large bills in March/April have been hedged and settled by banks and this has not generated excessive pressure on the exchange rate. The central bank was able to buy US\$19 million from the market in March this year.

The following structural reforms along with additional measures have been taken or are in the process of being taken:



- Restructuring of the central bank to be able to better focus on the core functions is making progress and the Monetary Board has approved an action plan. The World Bank is providing technical support.
- The central bank is in the process of strengthening the department of bank supervision.
- The statutory minimum capital adequacy ratios of commercial banks have been raised by 9 percent (with core capital of not less than 4.5 percent) with adequate notice given to the banks, from January 1, 2001. Minimum capital adequacy ratios effective January 2002, will be 10 percent, with core capital of not less than 5 percent.
- Private sector management teams have been appointed to the state-owned People's Bank and the Bank of Ceylon and restructuring plans are being prepared.
- The limit on foreign private ownership in commercial banks was raised in 2000 from 49 percent to 60 percent and in insurance to 90 percent.
- An insurance board was set up in March 2001, following the enactment of the insurance bill in parliament recently.
- The Finance Leasing Act was passed in August 2000 to give powers to the central bank to regulate and supervise the industry.
- Restructuring of the Ministry of Finance is underway to improve its efficiency.
- Private sector owned Housing Development Bank with equity participation from the IFC (among others) has been granted approval.
- A scriptless trading of securities among primary dealers and a funds transfer system is expected to undergo parallel runs before end April.
- The Colombo Stock Exchange introduced a number of changes to improve listing procedures to encourage the listing of more companies.
- A real time gross settlement scheme is being contemplated with technical assistance from the World Bank.
- Wheat importation and distribution is expected to be handed over to a milling company to take place during the first half of 2001 and the sale of further shares of Sri Lanka Telecom by June or July this year. The

two major state-owned insurance companies, already exposed to private competition, will be progressively restructured and privatized.

- Infrastructure development including through private sector participation in the ports, telecommunication, health, and power sectors has been making progress.
- The import tariff system was simplified further in 2000 to a two-rate band with a reduction of the maximum rate to 25 percent while keeping some agricultural products at 35 percent. The recent import duty surcharge is a temporary measure valid up to end of 2001.
- The government is considering the implementation of a flexible pricing mechanism for petroleum products as early as possible, and the World Bank will be providing technical assistance. Similar arrangements are contemplated for other state-owned utilities.
- Satisfactory progress has been made in the major reforms in these health and education.
- Several core groups/committees have been appointed to make recommendations on other areas of structural reforms, including capital market development, remaining exchange control regulations and labor market reforms.
- The World Bank and the Asian Development Bank in addition to some bilateral donors, who are already involved in providing assistance for some of the reforms mentioned will be providing further program support as indicated in the staff report. Some of the loan agreements have already been signed and funds amounting to US\$20 million were received in March. International market borrowing is expected during the second half of this year.

A working group consisting of officials from the Census & Statistics Department and the central bank has been assigned the task of developing a high quality consumer price index. This is required for the inflation targeting framework for the country. The authorities are making preparations to participate in the Special Data Dissemination Standards. In this regard, action is being taken to expedite the release of monetary statistics, improve the timeliness of quarterly national accounts and fiscal sector data. The authorities have also agreed to participate in the FSAP and a mission to Colombo is due in May for a preliminary assessment.

A framework for poverty reduction was published and this was presented at the Sri Lanka Development Forum held in Paris in December.

They are working on the specifics under the poverty reduction framework with a view to moving on to a PRGF arrangement as early as possible.

I look forward to the support of the Executive Directors for Board approval of the Stand-By Arrangement to help Sri Lanka, which is facing problems of macroeconomic stabilization in an inhospitable external environment.

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

We thank the staff for providing us with the basis for assessing Sri Lanka's recent economic developments within the context of the Article IV consultation and its request for a Stand-By Arrangement. Mr. Jayatissa's comprehensive preliminary statement further assures us of the authorities' resolve to address important macroeconomic and structural issues.

From the numbers, it is quite clear that the country has experienced some difficulty since 1999: (i) increasing fiscal and current account deficits; (ii) high inflation due to oil price hikes and depreciation of the rupee; and (iii) erosion of confidence on account of prolonged and costly ethnic conflicts. This situation has led to the rapid dissipation of reserves and an imminent foreign exchange crisis. Since late 2000, the authorities have intensified their efforts to stabilize the situation. It is important to note that the shift toward a floating exchange rate regime and renewed fiscal consolidation as well as the initiatives in achieving a peaceful resolution of ethnic conflict have helped avoid a further deterioration in the economic situation. The story of Sri Lanka is the story of many developing economies; a high degree of understanding by the other countries is of utmost importance.

Sri Lanka's situation is precarious and therefore it will require a strong program of adjustment. This is precisely what the program presented by the authorities for Fund support delivers. It is a strong program which aims to turn around the current difficult situation into one with greater stability and sustainable prospects for growth to be brought about by vigorous structural reforms. We support Sri Lanka's request and in so doing we would also like to make a few observations.

As the staff rightly pointed out, the success of the program relies mainly on fiscal consolidation. In this regard, it is important for the authorities to maintain their determination in cutting security-related expenditure by 1.25 percent of GDP in 2001 and a further 0.5 percent of GDP in 2002. Moreover, even in the face of unexpected ethnic disputes, the authorities are committed to abide by the fiscal principle that any extra spending should be fully supported by additional revenue measures. In addition, the rationalization of Samurdhi will help in containing the requirement for a social safety net by efficiently targeting the poorest of the poor. This will

ensure that the budget will make a difference in that respect. On the revenue side, in principle we support the staff's view that GST would lead to extra revenue collection. This is better than the alternative of simply relying on a rate increase in the NSL (National Security Levy). We recognize the authorities' position that increasing revenue by raising the NSL would create less public opposition than introducing a GST. In the long run, the over-reliance on the NSL needs to be phased out and the GST should be put in place as the main revenue source. While welcoming the FAD's plan for intensive technical assistance on this important issue, we hope the staff will closely monitor the outcome of fiscal consolidation, including the reduction of security-related accounts. At the same time, we reiterate our encouragement of the authorities in crafting a strong fiscal program that will address the lack of resilience in the tax system. We recognize the efforts of the authorities in putting in place various measures including those related to tax administration. Only when the revenue side is made more robust can one speak of meaningful fiscal consolidation. Expenditure reduction has its limits; important social expenses need to be considered in the trade-offs when putting the fiscal budget in order.

According to the staff, the unemployment rate remained at 8–9 percent even as the economy experienced relatively slow growth from 1999 to early 2000. However, unemployment among the younger population and in rural areas remains serious. Priority will therefore have to be given to increasing job participation rates in these areas over the medium term. It would be useful if the staff could provide some ideas about how to improve job opportunities and labor force participation.

The government's tendency to rely on borrowing from the financial sector (7 percent of GDP in 2000) has led to an increase in interest rates, some pressure in the foreign exchange market, and a weakening in the banking sector. In this connection, we welcome the authorities' intention to reduce public borrowings from the financial system in order to avoid crowding out the private sector. Consequently, as outlined by the staff, monetary policy can then focus on stabilizing inflation and augmenting reserves without having to put undue emphasis on ensuring the availability of liquidity for the private sector. With regard to the staff's assessment that the authorities' reduction of the repo rate was premature, we have some concerns: (i) whether such advice would be consistent with the recent global trend towards easing monetary policy and (ii) whether such a policy direction would contribute to stimulating the domestic economy.

With the help of vigorous export growth, restrained military imports and sluggish domestic demand, the current account deficit is expected to be reduced significantly in 2001. While a small financing gap will remain, support from bilateral sources will definitely help the authorities' efforts to reduce it. More importantly, an improvement in the security situation and a

more stable business environment will contribute to higher foreign direct investment, which has been constrained in recent years. Well-sequenced trade and capital liberalization will help facilitate the inflow of foreign investment. Of course, the key here is the restoration of market confidence in the Sri Lankan economy. We commend the authorities for their efforts in trying to stabilize the foreign exchange market in Sri Lanka with encouraging early results, as Mr. Jayatissa has outlined for us in his preliminary statement.

We seek some clarification from the staff with respect to the performance criterion on NIR. In the attachment, there are adjustors governing the computation of the NIR either upward or downward. What would explain the non-symmetrical adjustment of the NIR? There is full upward adjustment in case there is an excess in foreign program financing. However, in case there is a shortfall, limits have been specified on the amount of downward adjustment. This would make it difficult for the authorities to comply with this performance criterion in case such programmed financing does not come through.

Finally, in terms of the medium-term outlook, we hope the authorities will sustain implementation of various structural measures in accordance with their commitment to building a strong private-sector driven market economy. While we acknowledge the existence of some risks on account of ethnic conflicts or the deterioration of the external environment, Sri Lanka has enormous potential for further growth. This is especially so once the authorities are able to fully utilize the country's huge rural labor force. International society can play a constructive role in helping the authorities build a stronger, more sustainable economy. We also welcome Sri Lanka's efforts to improve its statistical system; including its preparation aimed at participating in the Fund's Special Data Dissemination Standard (SDDS) and in a future FSAP.

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

Mr. Mozhin and Ms. Vtyurina submitted the following statement:

Despite fairly steady GDP growth in 2000 in Sri Lanka, the deterioration of the fiscal position continued, inflationary pressures emerged, and terms of trade deteriorated. The most worrisome development was the possibility of a foreign exchange crisis in late 2000, fears of which eventually led to the floating and the subsequent depreciation of the rupee. The internal conflict continues to be a drain on the country's overall economic situation and prospects. When one adds to the above a level of external debt of almost 70 percent of GDP, the economic situation in Sri Lanka starts to look problematic. Under these circumstances, we consider a requested SBA as an appropriate step to start seriously addressing the economic imbalances in the

country. The proposed program is not without significant risks, which can arise not only from domestic but also from exogenous factors. It is also a short term arrangement and will be quite limited in solving the country's deep structural problems. Therefore, while we support the current proposed arrangement, we see it imperative that the country enters into a PRGF arrangement soon after the completion of the SBA. Now, let us briefly comment on some areas of the program.

It is hardly surprising that yet another country has abandoned a crawling peg regime. Unfortunately, as in many other cases, it came at the high cost of a depletion of reserves and hikes in interest rates. While we welcome the floating of the rupee, it needs to be insured that the new exchange arrangement operates properly, with interventions limited to times of extreme volatility. In this regard, we have noted that the staff are apprehensive about the regulations issued by the Central Bank of Sri Lanka (CBSL) aimed at stabilizing market operations, which, in fact, may damage market confidence and erode market liquidity. The staff did not consider the speculation by commercial banks, cited by the authorities as a main reason for regulations, to be a major threat to the rupee. At the same time, the authorities claim that such speculation is disrupting the market and that after consulting with commercial banks and forex dealers, they have decided to safeguard against this sort of risk. This situation is not easy. On the one hand, we understand the authorities' desire to limit possible overshooting of the floating exchange rate in the market with a relatively weak foreign reserve position. On the other, we share the staff's aforementioned concerns. It seems, though, that these conflicting views should be avoided at the time of a delicate situation in the forex market. We encourage the authorities to promptly eliminate these somewhat controversial measures.

To counteract the inflationary pressures and to contain further rupee depreciation, the decision to maintain a tight monetary policy is appropriate. There are quite a few challenges to the inflationary objectives. The lagged effect of the increase in administered prices and the possibility that government borrowing will not decline significantly, especially if the privatization receipts are less than expected, could make monetary policy management considerably more difficult. The staff are proposing the adjustment of monetary targets during the year because of the uncertainty surrounding the money demand projections, and we agree with that. In this vein, we wonder if the staff would see merit in informal quarterly monitoring of the monetary targets, like it was recently decided in the case of Vietnam, where the situation in the monetary area is similar in its uncertainty. Lastly, we would agree with the staff that the recent interest rate decreases seem to have been premature.

The deterioration of the public finances was significant and made the need for the consolidation even more apparent. An improvement of almost

two percent of GDP in the fiscal deficit will be a challenging task. We welcome the authorities' intention to achieve this reduction through improvements in tax collection, tight control of expenditures and lower security spending. Regarding tax collection, the target appears to be reasonable since it would be mainly achieved through increases in taxes and surcharges. Nonetheless, the outcome could be lower if economic activity slows more than expected. We are apprehensive, though, that, given the fiscal difficulties, the shift from NSL to GST and the phase out of concessions will only be implemented in the 2002 budget. The compression of current expenditures and domestically financed investment spending, and curbing of wage increases seems to be a common response to curtailing budget deficits. It would be important to adhere to the targets in full and to have the contingency measures ready since there may always be a request for additional military spending. As to the latter, while understanding the authorities' difficult position of dealing with a full blown internal conflict, we strongly encourage them to preserve the military spending targets agreed under the program.

The reduction in domestic debt financing is expected to be helped by a surge in the privatization proceeds. This is desirable, but the assumption is rather risky, especially given a complete lack of privatization activity in the past two years. The underperformance of privatization proceeds will lead to more commercial borrowing, further depress the domestic credit market, and delay the improvement in the country's debt profile. It would be prudent to be prepared for a worst-case scenario.

With the difficulties posed in the fiscal and monetary areas, one would hope that the vulnerabilities of the financial system are limited. In the case of Sri Lanka, vulnerabilities exist, especially when it comes to weaknesses in the state-owned commercial banks, the overall high levels of nonperforming loans and declining provisions. We have noted, though, that there have been some positive steps towards improving the soundness of the financial system, especially in enhancing performance of the People's Bank and the Bank of Ceylon, as well as strengthening regulation and supervision. In addition, recent initiatives to increase the limits of foreign participation in banks and insurance companies should receive a positive response from the markets. We welcome the confidence expressed by the authorities and by the banking community that the stabilization program should not unduly harm the performance of this industry as long as the economy continues to grow. Having said this, it is important to preserve the pace of the reforms in this sector to avoid the potential cost of bank restructuring on the already depressed public finances. We also welcome the scheduled FASP.

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

The case of Sri Lanka before the Board could be called a classic example of a balance of payments crisis. Increases in fiscal outlays in response to the 17 year long civil conflict, compounded with a sharp increase in their main import product—oil—have pounded an economy recovering from the aftermath of the effects of the Asian crisis. Downward pressure was placed on the currency despite an increase in interest rates, and although the band was released and the currency allowed to float, huge amounts of foreign reserves had already been lost in efforts to sustain the value of the Sri Lankan rupee.

In the 1999 Article IV discussion this chair stressed that in order for the authorities to tackle the many remaining structural problems and poverty issues, Fund assistance, possibly under a PRGF-supported program, should be considered in the near future. A year and one-half later, there are still many structural issues that have not been dealt with, as well as serious poverty. However, it will be necessary to stabilize the economy first through the SBA program, in order to set the stage for medium to long-term economic issues.

Taking into account Sri Lanka's balance of payments needs, the SBA phasing will be widely up-front. We basically support this, given the emphasis on demand restraint, a strong stabilizing aspect of the program supported by the SBA. This program actively deals with public sector restructuring, and for this we commend the efforts of the authorities and the central bank. Given the difficult situation the authorities are in at this stage, the targets set for fiscal policies seem challenging, and the staff's assumption on the base case (Table 5) somewhat optimistic. We agree that there are substantial program risks, but we hope the authorities' determination will see this program through. In the event they are able to strongly implement stabilization measures, the authorities face the further task of paying attention so as not to overkill the economy. To meet both of those requirements will not be easy, as it demands delicate handling of policies; but we look forward to their skillful management in order to regain market confidence.

As mentioned earlier, the most serious problem is the exacerbated fiscal position due to the conflict; and the need for revenue strengthening is more pressing than ever. We can go along with the authorities' policy to increase the NSL instead of the GST, which apparently begs for public understanding, but we agree with the staff that from a longer-term perspective, it would be more desirable to respond to that need by expanding the GST. On military expenditure, we note the authorities' intention to cut back in this area. It is of utmost importance in implementing their program and we urge them to do so as planned. If, however, military outlays exceed the initial target, the contingent measures of revenue strengthening and expenditure cuts should be



introduced quickly if not immediately to avoid any further slippages in the budget.

Concerning Sri Lanka's debt sustainability, the staff concludes that there is no cause for concern, given their good track record on debt repayment to creditors (including the Fund) and that 90–95 percent of their debt is on concessional terms. However, the proportion of external debt to GDP is on the rise, and in view that the government's debt repayment amounts to nearly one-third of revenue for 2001, we must note that fiscal rigidity is increasing due to the debt burden. Therefore, we would ask the authorities to make prudent decisions in their external borrowing, even if on concessional terms.

The authorities intend to deal with the issue of alleviating the public sector's burden on the budget indirectly by raising administered prices, and directly by actually restructuring public entities and closing down redundant agencies. For the former, we welcome steps taken by the authorities as a form of prior action, as this will contribute to assisting the ailing public corporations' financial situation. For the latter, as progress has been slow in the area of restructuring of the public sector, we urge the authorities to implement the above measures with determination and without delay.

The issue of privatization of public enterprises is important not only because of its impact on alleviating pressures on the budget, but also because of its effect on the balance of payments. Looking at Table 4, it is foreseen that privatization proceeds will amount to \$275 million in 2001, amounting to nearly half of the long-term direct investment, and \$100 million in 2002. These are substantial amounts, and we hope that the procedure will be carried out with transparency. At the same time, we feel that there is the risk that such privatization will not proceed as planned; we would therefore like to ask the staff where the risks lie and how high the risks are of privatization not moving forward.

On monetary policy, we support the staff's advice to maintain a tight monetary stance to alleviate pressure on the current account and to raise the level of foreign reserves. Needless to say, premature loosening of policy when the exchange rate is still unstable should be avoided.

We welcome how market discipline has been strengthened in the banking sector with the introduction of new accounting standards, strengthened supervision, and a regulatory framework. Also, we hope that restructuring will be accelerated in the People's Bank and the Bank of Ceylon, now that they have representatives from the private sector on their Boards.

Over the near to medium term, it will be essential to invite foreign direct investment, not only from the viewpoint of strengthening the competitiveness of the textile industry, but also to diversify the export base,

which is still quite dependent on textiles. We welcome the elimination of the preferential Board of Investment tariff regime because of its inefficiencies of parallel administration. It may be difficult in the short run to bring back direct investment, which has been affected by civil unrest. However, given that many export products are in direct competition with the ASEAN countries, should it not be necessary to further review investment incentives and formulate an action plan in this area? We would appreciate information on any discussions between staff and the authorities on this subject, or on any initiatives taken by other IFIs.

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

Mr. Dañri and Mr. Ahmed submitted the following statement:

As Mr. Jayatissa's comprehensive statement brings out, the Sri Lankan economy is passing through difficult times. Although growth and export performance was quite favorable, the combination of a series of adverse domestic and exogenous shocks has placed immense strains on the fiscal and external current account position. As a consequence, official reserves declined significantly, heightening the risk that the economy could be headed for a balance of payments crisis unless strong corrective policies are quickly put in place.

Against this background, we greatly welcome the authorities' program of stabilization and reform, in support of which they are requesting a Stand-By Arrangement. The program is appropriately ambitious and well-formulated, and seeks to achieve a major improvement in the financial position of the public sector in the context of a floating exchange rate. While the program, quite rightly, has a strong stabilization content, it recognizes that stabilization needs to be accompanied by a substantial acceleration of structural reforms, if the economy is to return to a sustainable growth path and poverty is to be reduced.

Given the high level of the fiscal deficit, the program appropriately accords the highest priority to achieving a significant improvement in public finance. On the revenue side, we agree with the staff that it would be preferable not to continue to rely on the National Security Levy (NSL) at the expense of the GST. However, we sympathize with the authorities' view that, in the short term, raising resources from the GST—an apparently highly unpopular tax—would be a more challenging task and would require a number of administrative improvements. In any event, we are pleased to note that over the medium term Sri Lanka is committed to a shift toward greater reliance on the GST—in tandem with phasing out the NSL—and that FAD technical assistance will provide advice on how this might be accomplished by the time of the 2002 budget. On the design of the GST, we suggest to focus

on drastically reducing exemptions and extending the GST to large retail outlets rather than increasing the GST rate further. We attach special importance to the steps being taken to strengthen tax administration. On the expenditure side, we commend the authorities for the measures aimed at curbing the wage bill and security-related spending. The budget also reflects Sri Lanka's long-standing attention to social sector and poverty-related issues, and we welcome the measures taken to achieve better targeting under the various social safety net mechanisms.

We are pleased with the authorities' bold steps in the area of administered price increases and for their commitment to set up an automatic pricing formula for petroleum product prices and to liberalize importation. As the staff note, these measures should help improve the profitability of key public enterprises, including the Ceylon Petroleum Company (CPC). However, price adjustments need to be accompanied by accelerated restructuring to improve the performance of the public sector and to make further progress in privatization. With regard to the latter, a number of transactions are underway and it will be important to ensure that they are completed by the second half of this year.

Monetary and exchange rate policy is especially challenging. We agree with the staff that monetary policy needs to remain tight until the economy stabilizes, inflation recedes, and foreign exchange reserves start to increase to more satisfactory levels. The authorities are to be commended on their bold decision to move to a floating exchange rate and for their commitment to allow the exchange rate to move in line with market forces. We are confident that the exchange rate will stabilize further, once the strength of the authorities' adjustment effort is felt, and policy credibility enhanced. Mr. Jayatissa provides a cogent explanation of the need for several prudential measures as safeguards against excessive exchange rate speculation as the new regime is tested by markets and underscores the temporary nature of these actions. We are glad to learn that the process of easing these prudential measures has already begun and encourage the authorities to take advantage of any upward pressure on the rupee to build up reserves.

Important improvements are underway in the financial sector, including good progress in the performance of the two large state banks. We support the government's decision to keep pressure on the People's Bank to restructure and improve operations with any decision on recapitalization being conditional on prior implementation of reforms. We are encouraged by the recent performance of the Bank of Ceylon. There is scope for further improvements in the supervision and regulatory functions of the central bank, and we welcome the authorities' intention to revise the relevant acts to provide support for their reform efforts. Sri Lanka's decision to participate in the FSAP in 2001 is praiseworthy.

The staff indicate that the stabilization program entails significant risks, both in the immediate and the medium term. Budget implementation will not be easy, especially if the political and security situation turns out to be less favorable. Moreover, the economy remains vulnerable to a variety of shocks. However, there are, as the staff note, a number of positive, mitigating factors: the authorities have taken strong measures and are off to a good start with their stabilization efforts, and their structural reform agenda is comprehensive and appropriately ambitious. More importantly, Mr. Jayatissa's statement has been extremely helpful in conveying the authorities' strong commitment to the program. Under the circumstances, we have no hesitation in supporting the authorities' request for a Stand-By Arrangement, and hope that, with solid implementation, Sri Lanka will be able to make a transition to a PRGF-supported program.

Mr. Djojosebroto and Mr. Bhatta submitted the following statement:

We thank the staff for a well-written set of papers and Mr. Jayatissa for his comprehensive preliminary statement. Although GDP grew by 6 percent in 2000 and the unemployment rate declined due to increased economic activity in the private sector, Sri Lanka's economy is still beset with many macroeconomic problems. Continued inflationary pressures since mid-2000, the widening current account deficit, and the low level of foreign exchange reserves are the major areas of economic concern for Sri Lanka at present. We are in broad agreement with the thrust of the staff appraisal of Sri Lanka's economy and would, therefore, like to concentrate our comments on only a few issues.

Since fighting poverty remains one of the main challenges for Sri Lanka, resolving various macroeconomic imbalances should be the authorities' priority in order to sustain economic growth in the long run. However, macroeconomic management and structural reforms have been adversely affected by the prolonged and costly 17 year-old conflict and the economic and social costs of the war have remained high with a serious impact on poverty in Sri Lanka.

Given the relatively large share of the public sector in Sri Lanka's economy, the proposed measures of fiscal consolidation to be undertaken by the authorities during 2001-2002 are indeed quite significant. We understand that resolving fiscal problems is not an easy task, especially under the current environment of the lingering civil conflict—which remains one of the main factors behind the expenditure over-runs. In this context, we commend the authorities' commitment to negotiate a peace settlement as mentioned by Mr. Jayatissa in his preliminary statement. We are also encouraged by the initiative taken by the Government of Norway towards finding an amicable solution of this problem. We feel that the resolution of the 17-year-old internal conflict will definitely help to create a conducive environment for the

implementation of structural reforms and thus encourage investment, particularly foreign direct investment, in Sri Lanka.

As elaborated by Mr. Jayatissa in his preliminary statement, the government is firmly committed to contain the deficit as early as possible with a view to achieving a relatively low sustainable budget deficit over the medium term. In this context, we welcome the measures as outlined in Box 3 of the staff report. We would suggest to the authorities to improve their expenditure management system and encourage the increased flow of resources towards capital and social expenditures.

On the revenue side, the performance of GST has been disappointing due to the existence of various exemptions and administrative problems. We, therefore, suggest to the authorities to strengthen tax administration and limit tax exemptions so as to increase revenues.

Price and exchange rate stability are rightly the main objectives of monetary policy in Sri Lanka. However, the task of monetary policy is difficult due to continued pressures arising from the fiscal position. The high fiscal deficit has so far constrained the ability of monetary policy to fight inflation, pushing up interest rates and thus adversely affecting the business and investment environments. Therefore, we urge the need for more coordination between monetary and fiscal policies.

For the effectiveness of monetary policy, a sound banking system is of utmost importance. The condition of the banking sector, particularly the condition of the state owned commercial banks, is weak with a relatively high rate of nonperforming loans. Efforts should be made to enhance the efficiency of such banks by improving their management and ultimately privatizing them to restore commercial viability. We welcome the authorities' decision to increase competition in the banking sector by raising the limit on foreign ownership of commercial banks from 40 to 60 percent. We share the staff's view that regulation and supervision of the commercial banks should be strengthened for the safety and soundness of the banking system in Sri Lanka. In this context, we welcome Sri Lanka's intention to participate in the SDDS and FSAP in 2001.

With these remarks, we support Sri Lanka's request for a Stand-By Arrangement and wish the authorities every success in facing their challenges.

Mr. Rustomjee and Mr. Campos submitted the following statement:

I would like to thank the staff for providing a useful set of papers and Mr. Jayatissa for his comprehensive and helpful preliminary statement.

Over the past decade the Sri Lanka authorities have made commendable progress in improving the macroeconomic environment and ameliorating the standard of living of the people of Sri Lanka. GDP growth was relatively strong, and was accompanied by relatively low unemployment and low inflation. This performance was supported by the introduction of a range of structural reforms, in particular, the liberalization of financial markets and measures aimed at increasing the outward orientation of the economy. A satisfactory record of privatization also characterized the period.

From late 1999, the economic and financial performance has, however, been affected by the deterioration of the terms of trade as well as the impact of the civil conflict. Despite real GDP growth of 6 percent, led by record exports between mid-1999 and the third quarter of 2000, the economic situation deteriorated in the fourth quarter of 2000, as the monsoons affected agricultural output and high interest rates worsened the business environment. The depreciation of the exchange rate and increases in prices of fuel and other administrative prices contributed to an increase in inflation which, on a twelve-month basis, rose from 4 to 11 percent by December 2000. After a reduction in 1999, the budget deficit deteriorated to about 9.5 percent of GDP while domestic borrowing by the government rose to 7 percent of GDP, reflecting higher security related expenditures. In addition, by late 2000, Sri Lanka manifested low reserves, and large import bills due, suggesting the possibility of significant capital flight.

I am pleased to note that the Sri Lankan authorities are well aware of the difficult situation and have prepared a strong program of adjustment to tackle the economic imbalances. To support the program, the authorities have requested access to SDR 200 million, equivalent to 48 percent of quota under a Stand-By Arrangement. Considering the large balance of payments need and the necessity to build up reserves as well as to boost market confidence, I support the Sri Lankan authorities' request. As stated by the staff, Sri Lanka's track record of discharging obligations to all creditors, including the Fund, has been consistently good and the Fund's exposure to Sri Lanka will remain limited, relative to Sri Lanka's capacity to generate resources.

I would, meanwhile, like to make a few observations. First, in our view, fiscal policy should move forward at a quicker and more effective pace towards consolidation. In this regard, I strongly welcome the objective to reduce the overall deficit to below 5 percent of GDP over the medium term. To this extent, the authorities' determination to cut security-related expenditure by 1.25 percent of GDP in 2001 and a further 0.5 percent of GDP in 2002 is welcome. Second, the authorities should also implement the reform of the tax system and pursue their plans to reform public institutions and press ahead with civil service reform. As pointed out by the staff, the increased public savings would allow expansion in investment, while containing the external account deficit and limiting any building-up of debt.

On the external side, I welcome the Sri Lanka authorities' decision to abandon the crawling peg regime and leave the rupee to freely adjust to market conditions. The central bank now has to focus on building up reserves and the preservation of export competitiveness. In this regard, and as recommended by the staff, I would suggest that the authorities review the regulations issued by the CBSL with the aim of stabilizing market operations.

As regards monetary policy, I note that the authorities are committed to maintaining the monetary stance at an appropriately tight level to offset inflationary pressures. However, the staff's concerns stemming from premature easing of interest rates are legitimate and I recommend that the authorities monitor the situation closely and take appropriate action if necessary. I also agree with the staff's proposal of adjusting monetary targets during the year because of the uncertainty surrounding the money demand projections.

The authorities' structural reform agenda is sufficiently comprehensive. Mr. Jayatissa, in his detailed and helpful statement, has exhaustively listed the measures the authorities intend to carry out in the area of structural reform and I fully encourage them to pursue these initiatives all of which will eventually contribute to strengthening macroeconomic performance. In particular, I welcome the implementation of the action plan for the restructuring of the central bank so that it can better focus on its core functions, along with the ongoing preparation of the plans for the restructuring of the state-owned People's Bank and the Bank of Ceylon. It is also pleasing to note that the development of infrastructure in the ports, telecommunications, health and the power sectors has been making remarkable progress through private sector participation.

Last but not least, I hope that the authorities will soon be in a position to request a PRGF arrangement, to be able to address the challenges that face the economy and to make the effort to reduce poverty and improve the well being of the people of Sri Lanka. I look forward to the Board's discussion of such a program.

Mr. Xu made the following statement:

At the outset, let me thank the staff for the well-written papers and Mr. Jayatissa for his very helpful preliminary statement. We commend the authorities for their consistent efforts and progress in tackling the macroeconomic issues in structural reforms over the past year. Output in Sri Lanka performed well over the past year. Real GDP grew at more than 6 percent between mid-1999 and the third quarter of 2000. In the fourth quarter, growth eased, despite continued record exports, as adverse weather conditions affected agricultural output and high interest rates depressed investment sentiment. Inflation stood at 11 percent last December, mainly due

to the rupee depreciation and increased administrated prices on fuel, wheat, transport fares, and public utility charges. As an oil-importing company and given higher world oil prices, Sri Lanka also suffered worsening terms of trade in 2000. Late last year, Sri Lanka faced strong pressure on official foreign reserves and the exchange rate as a result of higher oil prices and increased security-related imports. The current account deficit rose to 7 percent of GDP in 2000 from 4 percent of GDP in 1999. Official reserves declined by US\$613 million in 2000, even with higher capital inflows. However, the authorities lost no time in taking immediate action to address the problem. For the medium term, the macroeconomic framework envisages annual growth of 5–6 percent of GDP, with inflation moderating to below 5 percent by 2004, the overall fiscal deficit declining to 4.5 percent of GDP, and the external current account deficit falling back to 2.5 percent of GDP, financed with rising private capital inflows. For the short term, preventing an imminent balance of payments crisis has become the immediate challenge for the authorities. Against this background, there is a strong need for support of a Fund Stand-By Arrangement (SBA). More importantly, with a Fund SBA, the large balance of payments need could be met, reserves built up and market confidence strengthened. It is encouraging to see that the last prior action was completed with the increase in administered prices on April 15—clearly demonstrating the authorities' strong commitment and ownership of the program. Therefore, we fully support the authorities' request for a SBA and the proposed decision on page 29 of the staff report. In fact, given the country's financing needs, its previous track record and capacity to service its external debts, we could support a higher access than the figure proposed in the report.

The fiscal position in 2000 worsened because of revenue shortfalls, increased interest payments, and deteriorating external factors, including oil price increases. Under the circumstances, the authorities reacted quickly to reduce lower priority expenditure and increase taxes on tobacco and the National Security Levy.

Looking ahead, the authorities are fully committed to tackling the fiscal deficit in a timely fashion. The 2001 budget targets the overall deficit at 8.5 percent of GDP in 2001 and 5.5 percent by 2003. With the new budget's envisaged measures, the deficit is expected to be reduced by more than 3 percentage points of GDP from the baseline scenario. In the meantime, the new budget also aims to extend coverage of the Large Tax Payer Unit to include large GST taxpayers, and harmonize tax and the dual Customs regime for export processing zone companies. In this regard, we certainly encourage the Fund to provide technical assistance to improve the tax system and tax administration in a timely manner.

Given the low official foreign reserves and high inflation, the Central Bank of Sri Lanka should be geared to bringing inflation to a low single digit



range while rebuilding reserves. Inflation is currently projected to decline to 8 percent, on a 12-month basis, by end-2001 and to 5 percent by the end-2002. In this connection, it is encouraging that "the central bank is focusing on making further improvements in the conduct of policy in the context of a flexible exchange rate system with a view to adopting an inflation-targeting framework" as stated in Mr. Jayatissa's preliminary statement. On exchange rate policy, the central bank should continue the current flexible exchange rate policy allowing the rupee to respond to market forces while the CBSL should intervene to build up reserves and dampen unnecessarily high volatility.

Despite economic growth in recent years and extensive welfare programs, one-fifth of Sri Lanka's population still lives below the poverty line. To sustain sound growth and reduce poverty, the authorities' efforts deserve Fund support through the PRGF. We, therefore, encourage the authorities to move forward in preparing the poverty reduction framework and look forward to supporting their request for a PRGF arrangement based on successful implementation of the present SBA.

Finally, we reiterate our support for the proposed decision and wish the authorities continued success in their macroeconomic adjustment endeavors to achieve sustainable growth.

Mrs. Mateos y Lago made the following statement:

After a decade of strong growth and significant achievements in improving the economic environment and standards of living in Sri Lanka, macroeconomic policy slippages, a marked slow down of structural reforms and a couple of exogenous shocks combined to bring the Sri Lanka economy to the brink of a currency crisis and well into balance of payments difficulties. Under such circumstances, it is quite natural for the authorities to turn to the Fund to limit the output costs of the necessary adjustment. And, in principle, we would be quite open to supporting a request for Fund assistance, provided we had sufficient reasons to believe it would reach its objective. However, as they stand, we are not convinced that the program put together by the authorities and the SBA itself will stem and eventually reverse the worsening of economic imbalances which occurred since the last Article IV consultation.

Beginning with the concerns related to the economic program laid out in the authorities' Memorandum of Economic and Financial Policies (MEFP), they are essentially threefold. First of all, we fear the underlying assumptions regarding export growth, foreign investment and the inflation outlook might be unduly optimistic, especially in light of respectively the expected slowdown in Asia, which absorbs over 63 percent of Sri Lanka's exports and the significant depreciation of the rupee in recent months. Adverse developments in any of these respects would tend to widen the financing gap and/or call for further tightening macroeconomic policies. In this connection,

we fully endorse the staff's warning against a premature easing of monetary policy.

Second, we are skeptical concerning the ability of the authorities to actually achieve the fiscal adjustment effort embedded in the budget, whose recent approval by Congress is encouraging, but whose execution could be subject to just as many slippages as last year. A major uncertainty, in that regard, is whether it will be possible to contain security expenditures within the budget envelope, or to compensate for overruns by curtailing spending in other areas, yet preserving social spending. Another uncertainty in view of past performance is the extent to which revenue enhancing measures will actually translate into higher revenue. Bolder measures to improve tax compliance and a more candid recognition of the governance problems which plague the tax and customs administration would have been warranted in the program.

Third, we fear the structural reform efforts envisaged under the program fall short of what is needed for growth to accelerate in a sustainable manner and vulnerability to be reduced, especially in the financial sector. In that respect, we welcome the authorities' decision to participate in the FSAP and hope that it will serve to boost the momentum for reform in that sector. But the lack of concrete commitments regarding the reforms of the bloated public sector, the labor market and the pension system is also a concern, especially at this very favorable stage of the political cycle. Failure to take bold action in those areas could severely hamper the restoration of investor confidence as well as prevent part of the financing expected from the official sector from materializing.

Turning now to SBA design issues, we are troubled by two aspects, namely the format of conditionality and the schedule of purchases. Regarding the former, our main concern is the lack of adequate performance criteria related with fiscal policy. Fiscal adjustment is the cornerstone of this program, and failure to achieve it would most probably jeopardize the attainment of program objectives, both domestic and external. Therefore, simply setting a ceiling on banks' net claims to the government is wholly insufficient, especially given that banking financing accounted for only 43 percent of total deficit financing in 2000, and just under 50 percent of domestic financing. That criterion is binding only when taken in combination with revenue, debt and deficit targets, which are only indicative here. I think the program would be a lot stronger if these indicative targets could be turned into performance criteria. Likewise, considering the importance of the structural reform agenda for the success of the program, I think the absence of structural performance criteria is unfortunate, especially in the areas of taxes and price liberalization. I also find it hard to justify the absence of any conditionality, even of the loose kind, related to private banks, whereas the staff appraisal contends, rightly,

that strengthening the financial system and increasing its efficiency should be a priority.

As regards the schedule of purchases, I understand that the massive frontloading of disbursements stems from the combination of first credit tranche policies with the relatively modest level of access under this arrangement. While that may be unavoidable, it still results in weakening the incentive to sustain the adjustment and reform effort beyond the first disbursement. To some extent, that could have been mitigated by requesting the completion of significant prior actions, to ascertain the strength of the authorities' commitment. But the prior actions listed in the report hardly qualify for that purpose, being limited both in quantity and in scope, with the exception of the shift to a floating exchange rate, for which there was not really any alternative given the very depleted level of reserves. This is not without raising uniformity of treatment questions. Against this background, we would strongly prefer a rescheduling so that purchases beyond the first disbursement be more in line with actual progress of structural reform.

To wind up, in light of the above mentioned concerns, particularly those related with program design, and notwithstanding our willingness to support reform and adjustment in Sri Lanka, this chair would like to be recorded as abstaining.

Mr. Whitehall made the following statement:

Sri Lanka has exhibited favorable growth and export performance over the last decade, despite the costly and prolonged ethnic conflict (over a period of seventeen years). Apart from the conflict, the economy has been hindered by the slow pace of structural reform and its vulnerability to external shocks, such as sudden increases in oil prices and deterioration in the terms of trade. In recent times the result has been an increase in debt, higher interest rates, balance of payments difficulties, and higher inflation. We have reservations about the proposal and wish to comment on a few specific issues.

First, the program is ambitious and entails significant risks, including the substantial fiscal adjustment required, and the vulnerability of the security situation. The economic outlook presented by the staff appears optimistic for the most part. We are a little skeptical about the forecast that the external current account will decline from 6.8 to 3 percent, and that the fiscal deficit will decline from 9.8 to 5 percent in the medium term. These developments are expected to result from an improvement in the terms of trade, and containment of military imports and domestic demand owing to a tighter policy framework.

Second, we are heartened by the commitment of the government to work toward privatization, monetary targeting, reform of the central bank and

other structural reforms. But we are worried about the government's capacity to implement these reforms in the current environment of preoccupation with security issues and in the absence of a PRGF-supported program.

We commend the government for its decision to increase fuel prices in response to the increase in oil prices. However, prices are administered for a wide range of goods and services and we encourage the authorities to persevere with efforts to liberalize these markets, in order to increase efficiency and reduce shortages.

Third, like other Directors, one of our key concerns is the level of military spending. We note that defense spending is estimated to have increased from 3.6 to 4.6 percent of GDP in 2000. Military spending burdens the fiscal accounts and increases external debt without necessarily leading to a lessening of hostilities. Economic management in the context of prolonged ethnic violence is challenging and there are risks to investor confidence from the potential for sudden changes in the security situation. Therefore, we are happy to hear of the authorities' commitment to a negotiated peace settlement and encourage them to persevere in their efforts to lessen and eventually resolve these hostilities. When—and not if—this conflict is contained, Sri Lanka will indeed reap the benefit of what has been described as the 'peace dividend', and the true growth potential of the economy will become manifest. We share the views expressed by Mr. Djojosebroto that resolution of this conflict will indeed help to create the environment favorable to structural reform, private sector investment, and poverty alleviation. But structural reform cannot wait upon the resolution of the conflict, and thus we encourage the authorities to press ahead with their reform agenda.

Fourth, Sri Lanka is ranked in the ninetieth percentile in the Human Development Index, which is reasonably high, but we note reference to 'serious poverty' in the statement by Messrs. Yoshimura and Saito. If there are serious concerns about poverty then we would be even more concerned to ensure that Funds are channeled only in the direction of economic stabilization and poverty alleviation. It is important that the Fund should be careful about its role in these matters.

The recent balance of payments crisis should be seen as a wake-up call to remind us that economic growth will not always continue in the presence of unresolved conflict. The economy is no longer strong enough to accommodate such a heavy burden of defense expenditure. As we stated before, we have reservations about the SBA, but prefer to send a warning signal to the authorities at this time. Perhaps the authorities should be given another chance to improve their situation. Thus, we are willing to support the request.

With these remarks, we wish the authorities every success in their efforts as they persevere with their ambitious reform agenda.

Mr. Nardelli made the following statement:

It is regrettable that the current economic and political situation does not allow for the discussion of a PRGF-supported program. Such an arrangement, backed by a strong commitment of the authorities, would have certainly been more suited to addressing the comprehensive structural reforms that Sri Lanka urgently needs if it is to achieve medium-term sustainability. What we have before us today, instead, is the proposal for a Stand-By Arrangement that has been laid down in the wake of the currency depreciation of early 2001, which is by nature more limited in scope and mainly directed at covering the sizable financing gap that is projected for the current year. Nevertheless, we can go along with the proposal on the assumption that, in light of the sizable risks that the program faces, adequate monitoring will be in place and all targets and performance criteria are strictly adhered to. We therefore welcome the statement by the staff representative that, with the increase of the price for diesel and fuel oil, all prior actions have now been met.

The events that led to the decision to float the rupee are only partially beyond the authorities' control, and highlight in our view a pressing need for Sri Lanka to embark convincingly on the path of economic and structural reforms. The assurances provided in Mr. Jayatissa's preliminary statement in terms of the authorities' commitment to containing the fiscal deficit and to make progress in structural reforms are encouraging in this respect. Let me offer a few comments on these two areas.

Avoiding further overshooting of the central government deficit target will be critical for the credibility of the program. Of course, further military outlays cannot be ruled out should a solution to the conflict not be found as expected. Nevertheless, the authorities should stand ready to take prompt and effective corrective measures on the revenue side. In this regard, I would support the remarks made by Mrs. Mateos y Lago on the desirability to transform some of the indicative targets on deficit and revenues into performance criteria in order to strengthen the program. We would also advise the authorities to refrain from trying to offset fiscal pressures by slowing down investment programs, a strategy that could likely prove flawed over the medium-term. Moreover, the authorities should aim at discontinuing the practice to draw upon the surpluses of the pension funds to finance the deficit and should foster the development of the domestic government debt market. I associate myself with views on debt issues expressed by Mr. Yoshimura and Ms. Saito in their statement.

We agree with the staff that the NSL should be phased out in favor of a wider reliance on the GST. Although the authorities have a point in maintaining that the NSL is more acceptable in the taxpayers' minds because of its more immediate link with the national security situation, we believe that

it should not be overly difficult for the government to explain that the GST is not additional to existing taxes, but rather in substitution of the current NSL. The key to a smooth substitution process is an accurate synchronization of the decrease in NSL rates and increase in GST rates: we hope that, with the support of the envisaged technical assistance from the Fiscal Affairs Department, the authorities will be able to work out an adequate timing of the required measures.

Concerning the area of structural reforms, Sri Lanka is faced with a daunting agenda. Although the context of an SBA arrangement is not the most appropriate to undertake in an exhaustive manner such comprehensive reforms, the authorities should at least strive to set the stage for this complex process.

First and foremost, there is a need to overhaul the public administration. The Sri Lankan economy suffers from the weight on an oversized bureaucracy that has certainly played a role in the delays of a number of reforms. As noted in the RED paper, the number of central ministries is high at 45. The RED paper addresses the issue of the reform of the People's Alliance, but not with a broad enough perspective. In particular, the issue of redundancies in the civil service is not considered. It is also critical to undertake a reform of the pension system, which is currently not on a funded basis for public employees.

In the financial sector, we were encouraged by the improvement in the performance of the People's Bank and of the Bank of Ceylon, and urge the monetary authorities to continue to press for further improvements, which could in turn be beneficial to the whole banking sector as well. The listing of the Bank of Ceylon on the stock exchange could be an appropriate move in this regard. Like other Directors, we also welcome Sri Lanka's participation in the FSAP review.

Finally, we found the staff's call for a simplification of the labor market legislation very appropriate. This could also be instrumental in improving the environment for FDI in the country. Moreover, we noted from the RED paper that unemployment has been persistently on a downward trend since 1995 to present, while in this period the path of economic growth was mixed. In this regard, we would like to ask the staff what are the main effects of rigidities, such as weakness of the procedures for the resolution of labor disputes or the establishment of termination compensation, on the labor market.

Before concluding I would stress along with my French colleague that the combination of first credit tranche policy and the modest level of access under the program determines in this case an undue front-loading of the disbursements.

Mr. Taylor made the following statement:

We agree that this Stand-By Arrangement should provide a measure of support and stability in the short term, but I would also echo the comments of others about the long-term structural issues which remain to be addressed. We also recognize the sobering risk assessment which has been provided by the staff, including those economic vulnerabilities posed by the ongoing civil conflict. We thank Mr. Jayatissa for the reassurances given in his statement, but clearly this is a matter of deep and lasting concern.

Fiscal issues are of primary importance, and in particular the question of the public sector deficit and the need for fiscal consolidation. The first essential step is to place the deficit on a downward trend, including the proposed reduction in security-related expenditure levels. On the revenue side, the proposal to increase tax revenues by 1.75 percent of GDP in 2001 looks ambitious. It seems likely that there will be some difficulties with collection. We are less than encouraged by the authorities' reluctance to countenance an early increase in the GST, preferring instead to increase the National Security Levy. We agree with the staff views on the need to expand the GST base and reduce exemptions, accompanied by any necessary increase in revenue management resources. In that regard, we are pleased to note that the Fiscal Affairs Department is providing some technical assistance to help address weaknesses in tax administration.

On the expenditure side, we want to stress the importance of maintaining social expenditure levels. While it is the case that Sri Lanka's social indicators are impressive, the combined shares of public expenditure on health and education for 2001 still amount to just 4.4 percent of GDP. It would be most unfortunate if fiscal pressures were to lead to cuts in these areas. The government has now implemented reductions in the welfare program, and we would be interested to learn of the improved targeting on basic goods and services.

With total debt approaching 97 percent of GDP in 2001, while we agree that Sri Lanka does not have a particularly burdensome external debt ratio because of the concessional nature of that debt, interest payments are the largest item of government current expenditure at 6.3 percent of GDP. As others have remarked, increasing fiscal rigidity and reducing the government's debt service burden are clearly essential. We welcome the plans to reduce domestic debt financing in part through privatization, but we also share the concerns of Mr. Yoshimura and Ms. Saito that the planned privatization program may not proceed as quickly as planned.

We note the government's proposal for a public sector hiring freeze. We share the staff's views on the need to overhaul legislation to improve labor market flexibility in both the public and private sectors. We would be

interested to hear what plans have been carried out to eliminate vacant public sector posts, an issue which we have raised in the past.

Mr. Jayatissa reminds us that his authorities are working on a poverty reduction framework with a view toward a PRGF-supported program as early as possible. We would certainly stress our hope that the I-PSRP sets out a very clear road map for a comprehensive strategy with broad participation. The successful implementation of this Stand-By Arrangement will be critical with regard to our view on any PRGF proposal.

Finally, let me just add my voice to those of my French and Italian colleagues with regard to the issue of indicative targets and performance criteria. It may be appropriate to include the primary fiscal balance under a performance criterion. Staff comments on that area are welcome.

Mr. Bakhache made the following statement:

Notwithstanding favorable export and growth performance, macroeconomic developments in Sri Lanka have taken a worrisome turn recently. A multitude of factors, including a high import bill, intensifying political and security pressures, and delays in privatization contributed to pressures on the rupee. The widening fiscal deficit and increasing financing needs of public corporations also added to these pressures, as the public sector domestic borrowing requirement grew. These pressures led to a significant decline in official reserves as well as increases in interest in an effort to maintain the exchange rate peg. A balance of payments crisis almost ensued and the financial position of the corporate and banking sector was undermined. More fundamentally and from a long-term perspective, however, long years of public dis-saving, along with persisting structural weaknesses, have weighed heavily on the economy, thereby hampering its growth potential.

Against this background, the authorities' policy focus should be first and foremost on addressing the short-term macroeconomic imbalances. Steps in this direction have already been taken. The move to an operationally flexible exchange rate regime is a key element in the authorities' adjustment efforts. The recent relaxation of exchange regulations is a welcome step to allow for an efficient functioning of the market. To be effective and meaningful, the shift to a floating system should be complemented by tighter macroeconomic policies aimed at reducing the financing needs of the public sector and reining in inflationary pressures. The authorities' program appears to be adequately designed to address the short-term challenges. The program, however, entails a number of risks, which we believe can be minimized by resolutely adhering to programmed targets. Given that the authorities have already taken a number of measures to support the stabilization efforts, we are prepared to support their request for a Stand-By Arrangement.



Moving forward, fiscal consolidation is at the center of the authorities stabilization program. While the envisaged fiscal adjustment seems sizeable, we believe it is reasonable given the magnitude of the slippages in 2000. Still, achieving this target requires strong revenue measures and strict controls on spending. On the spending side, we welcome the planned freeze on public service hiring and the containment of the wage bill. This needs to be coupled with cuts in military spending to the extent afforded by the security situation. Given the risk of an escalation in the conflict the authorities should be in a position to take offsetting measures in case of overruns in security spending.

On the revenue side, we believe that increasing the GST rate is the preferable course of action to raise revenues. However, given the existing limitations on implementing such an increase, the increase in the NSL and import surcharges are an acceptable alternative. We attach considerable importance, however, to reversing these measures and expanding the GST base, starting in 2002. Tax administration also needs to be strengthened to ensure among other things that the GST is effectively implemented.

Strengthening the fiscal position should facilitate monetary management and leave room for private sector credit to grow. The conduct of monetary policy was complicated last year by the uncertainty surrounding the rupee and the need to increase interest rates in this environment. At present, within the framework of a flexible exchange rate system, the central bank can refocus its policy on bringing inflation down to single digit levels and rebuilding reserves. Given the importance of a tight monetary stance for restoring macroeconomic stability, like the staff we are somewhat uncomfortable with the recent easing of the interest rates. Like Mr. Yoshimura and Ms. Saito as well as previous speakers, we believe loosening of policy should await signs of significant strengthening of confidence.

On the financial sector, we share Mr. Dañri and Mr. Ahmed's views and welcome the authorities' decision to undertake an FSAP.

As stated above, the economic problems in Sri Lanka are rooted in long-standing weaknesses. We share other Directors views that the authorities should be looking beyond the Stand-By Arrangement and toward a program that would more comprehensively tackle structural issues including civil service reform, state monopolies, and financial and labor market reforms. Special attention will have to be accorded to poverty issues including appropriate funding for priority sectors.

Finally, we wish the authorities success in tackling the current challenges and those that lie ahead.

Mr. Kiekens made the following statement:

The most important aspect of Sri Lanka's program—the success of the peace initiative—is beyond the core competence of the IMF and even of the International Financial Institutions. Ongoing civil strife in Sri Lanka has caused a crisis arising out of competition between external and fiscal expenditures. More than one-third of revenue is needed for security and defense related expenditure. Another one-third of expenditure services interest payments. Only one-third of expenditure is left to pursue the needed policies in terms of social transfers, education, health care, and needed infrastructure work.

I am prepared to support the Stand-By Arrangement but with clear understanding that the government will make its utmost effort to use this international support to continue to deepen the stabilization that has taken place, and to continue the structural reform program. Both are essential to obtain the needed external financing for this program to be fully financed. Even then, the numbers are challenging. On a net basis two years ago, Sri Lanka accepted \$100 million in external financing. Last year, one billion dollars was required and received. For 2001, Sri Lanka is projected to attract foreign financing of \$2.8 billion on a net basis. This shows how critically important it is for Sri Lanka to build further on the initial confidence that the Board today will give to the government in Sri Lanka by approving this Stand-By Arrangement.

The staff appraisal makes it clear that this is a difficult decision. The stabilization program entails significant risks, and they are primarily in the fiscal area. I agree with what my colleagues have said in this regard, including the need to build a more stable basis for revenues, and to preserve productive expenditures and to reduce nonproductive expenditures.

Several colleagues have made quite critical comments on the design of the program and in particular, the level of conditionality. I support this program with the clear understanding that on the occasion of the reviews, the indicative targets for fiscal objectives are taken very seriously, and that if there are slippages in the fiscal area for which the government can take corrective measures, that indicative target should be taken as a solid basis for deciding on whether the review should be completed.

Ms. Brukoff made the following statement:

While we recognize that the authorities are facing a difficult economic situation, we have serious reservations about using Fund resources in support of this program. The reform commitments do not seem particularly ambitious, and downside risks to the successful implementation of this program appear substantial. We are skeptical about the authorities' ability to contain fiscal

slippages and to follow through on structural reforms in light of unforeseen security developments, their prospects for raising needed budget financing via an overly optimistic privatization program, and their ability to secure the envisaged concessional and nonconcessional external financing.

We find it highly problematic that this request for Fund resources is intended to address balance of payments difficulties that resulted, at least partially, from last year's sharp increase in imports of military equipment. This is a matter of concern not only for this program, but also if we are looking ahead to the prospect of a PRGF-supported program. In the event that military spending does not decline as projected in the program, IMF and other IFI funds may in part end up replacing government resources diverted from social programs in support of security operations, providing flexibility for the authorities to continue to prioritize unproductive military spending over investments in development and poverty reduction. The authorities' expenditure prioritization will be a matter of great concern for this chair in the context for a request for a PRGF arrangement. We may also need to assess the prospects for implementing effective poverty-alleviating policies in the context of a worsening security situation.

Turning to specific elements of this program, we want to comment on the planned fiscal adjustment, and assumptions related to privatization and other sources of external financing.

The planned fiscal adjustment strikes us as insufficient to help the authorities achieve the goals of the SBA. Reducing the overall deficit by 1.3 percent of GDP would seem the bare minimum necessary to undo the unsustainable 1.2 percent of GDP increase in defense expenditures undertaken in 2000 that contributed to the current situation. This looks less like adjustment than a reversal of what we hope will be a one-off hike in expenditures. Even if this target is realized, the programmed deficit of 8.5 percent of GDP will remain higher than Sri Lanka's average fiscal deficit recorded prior to the recent period of military escalation. The scope for revenue mobilization efforts to contain fiscal slippage appears limited given institutional weaknesses and a declining tax-to-GDP ratio. Furthermore, even the relatively modest programmed adjustment could prove difficult to achieve in light of ongoing military operations and limited revenue buoyancy.

In light of these concerns, we would agree with the suggestion made by Mrs. Mateos y Lago for strengthening fiscal conditionality.

On the privatization program, the authorities' preoccupation with the ongoing civil conflict may continue to limit progress in this area. Given that privatization revenues yielded only US\$2 million versus a projected US\$340 million for 2000, the 2001 projection of US\$275 million seems rather optimistic.

On program financing, assumptions on the terms and timing of possible external financing appear overly optimistic. Expected World Bank financing may not materialize until 2002 since negotiations with the authorities are still in the early stages and the Bank's overall lending strategy is still being developed. We are also concerned about the authorities' real prospects for raising US\$200 million in international financial markets, in addition to questioning the appropriateness of taking on this much non-concessional debt given the country's already substantial debt burden and likely future request for use of concessional resources.

In conclusion, based on the serious reservations outlined above, we ask that our vote on this request be recorded as "abstain."

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

To meet the macroeconomic framework and projections over the medium term, the authorities will have to implement those structural reforms to which they are committed. The prospect that structural reforms will be implemented are reasonably good, which in turn means that the growth projections are not overly optimistic. At the same time, because of the downturn in Asia, doubts have been expressed about export prospects. Yet it should be noted that Sri Lanka has a fairly limited number of exports, and the market is particularly buoyant worldwide and within the European Union with regard to the tea and garment industries.

The authorities have committed to a very substantial adjustment program. If the overall deficit is considered, the size of the adjustment is underestimated, and in terms of the domestic financing implicit in the numbers, the adjustment in terms of GDP is between 4 and 5 percent. To achieve this target, current expenditure must be contained, including defense and security related expenditure, while revenue targets should also be met through various measures that are in the process of being implemented. There are definite weaknesses with regard to achieving the revenue targets, which the authorities recognize. Technical assistance is being provided, and the authorities are making every effort to improve their performance, particularly with respect to the GST. The staff notes concerns about the National Security Levy, but, as has been proven in the past, it is a very efficient tax collecting measure. In general, the staff are reasonably confident that the authorities will achieve the revenue target. The deficit should also be reduced significantly through privatization proceeds.

On expenditure, the authorities have already introduced fairly stringent cutbacks throughout the system to keep current expenditure as tight as possible. They are proceeding only with those capital projects which are

essentially foreign financed, and there are again reasonable prospects that the authorities will achieve the expenditure target.

The staff and the authorities discussed the program design quite extensively, and in particular what measures might be useful as performance criteria. The problem with measuring the primary budget balance is to find a precise number that would be readily available as a performance criterion and subject to the formal reporting standards. The authorities were reasonably concerned that, because the financing for some of the expenditure items are aid dependent, the authorities have an information base that is not as timely as it should be. It is clear that Sri Lanka receives quite a large amount of their financing from nonbanks, and in particular captive sources. In general, the staff knows exactly what those sources are, and how much they are lending, and we are monitoring that information informally on a monthly basis. In terms of the suggestion made by Mr. Kiekens, adherence to the indicative targets as benchmarks is a rigorous test in terms of the review process which is understood both by the staff and by the authorities.

Last year was a disaster for Sri Lanka in terms of privatization prospects, while this year looks much more positive. With regard to the wheat contract, the authorities have already received US\$25 million, and there are firm proposals which should deliver another US\$65 million this quarter. The largest element of the total structural reform program is the sale of telecom shares. The authorities have informed the staff this week that the preparations for the sale are in a fairly advanced stage. In terms of the total amount that is incorporated into the budget, and into the program, the staff have taken a very conservative view. The total value of what makes up the privatization package approximately amounts to US\$350–360 million, but the staff did not include this figure in the program because of concerns about the timing of some of these reforms. The staff hopes that by the first review, which will coincide with an analysis of financing assurances, that the level of privatization proceeds for the whole year will be clear.

On broader budgetary issues, the main social spending program, Samurdhi, has been targeted by the authorities to those who are not broadly covered by the category “poor.” There have been several studies, and the World Bank in particular has done a recent study on poverty. Poverty does exist in Sri Lanka, and has a fairly distinctive regional perspective. These issues are addressed in the authorities’ interim PSRP document, which should be brought before the Boards of both the Bank and the Fund by June 2001.

In terms of other questions raised, labor market reforms are critical to improving public administration performance. Progress needs to be made from liquidating redundant institutions to transferring people out of the public sector and into the private sector. A recent study on unemployment by the World Bank found a large level of voluntary unemployment, along with a

tendency for people to still want employment in the civil service as opposed to job opportunities which exist elsewhere in Colombo and other towns.

The staff has consistently cautioned the authorities against loosening monetary policy, and over the years Directors have supported this position. Before interest rates are lowered, the staff would like to see clear evidence that fiscal consolidation has obtained, inflation has declined to single digit numbers, and the exchange rate has stabilized at a rate with which the authorities feel comfortable.

The Deputy Director of the Policy Development and Review Department (Mr. Allen), commenting on the level of access under the Stand-By Arrangement, remarked that the annual rate of access was slightly above the average rate of access under Stand-By Arrangements over the course of 2000/2001. With regard to phasing, the guidelines made it clear that there was to be no phasing in the first credit tranche. If the first tranche was 25 percent of quota, then all of that tranche was available to the member country immediately on approval of the arrangement.

Mr. Vogel made the following statement:

First, we urge the authorities to address the serious macroeconomic imbalances that block the return to a sustainable growth path. In particular, we have concerns regarding the larger overall fiscal deficit, the deteriorated current account balance, the low level of international reserves and the climbing inflation rate.

In the fiscal area, further measures are necessary to achieve a sustainable fiscal position. In this regard, we agree with the staff that the VAT would be key for a new tax system that would be less dependent on the National Security Levy, excluding temporary duties and eliminating discretionary concessions.

The prolonged civil conflict undermines the business environment, and generates serious problems for financing the external imbalances. In late 2000, significant capital flight made sustaining the managed float of the exchange rate impossible. We understand the need to reform the exchange system, but we urge the authorities to avoid restrictions which would hurt business confidence even more.

On the monetary front, the low level of reserves and the high inflation rate underscore the need to tighten monetary policy. In this context, we agree with the staff that any premature easing of interest rates would be risky. Moreover, keeping in mind the difficulties of projecting the money demand, we have some doubts on the use of the money growth target as a nominal anchor for Sri Lanka's economy.

We welcome the intensification of the market discipline through prudential regulation and the application of accounting standards. However, further measures are needed to improve the soundness and efficiency of the banking sector, particularly to reduce the intermediation costs which limit the possibility of growth. We welcome Sri Lanka's participation in a Financial Sector Assessment Program review in 2001.

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

Mr. Haupt made the following statement:

Sri Lanka's difficult economic situation has deteriorated further recently. An unsustainable exchange rate regime was abandoned, but only after adverse terms of trade and budgetary overruns had contributed to a near-depletion of foreign exchange reserves. The Sri Lankan authorities have since put together a reasonably ambitious stabilization program. Steadfast implementation of its key components of deficit reduction, tight monetary policy and exchange rate flexibility will be crucial. In this regard, we join the staff and others in warning against premature interest rate cuts. While we support the request for a Stand-By Arrangement, we would, however, emphasize some critical elements and reservations.

First, as indicated by several other speakers, program risks are significant and perhaps somewhat understated in paragraph 61 of the staff document. Thus far, reserve coverage of short-term debt remains at a worrisome level. Moreover, some of the downside risks analyzed by staff in alternative medium-term scenarios may well coincide, thereby leading to worse outcomes. Notwithstanding Mr. Carter's somewhat reassuring comments, privatization proceeds may still fail to materialize as expected, in particular in the case of heightened security concerns, and/or a worse-than-expected external environment. The result might be an accelerated exchange rate depreciation followed by higher inflation and debt service costs.

Second, we are concerned by the degree of uncertainty surrounding the remaining external financing gap in 2001. We welcome the update provided in Mr. Jayatissa's and the staff's helpful preliminary statements. Additional information would be appreciated on when program and project loans from the World Bank and the Asian Development Bank are likely to be forthcoming.

Third, on fiscal, last year's overruns of security-related spending and the civilian wage bill highlight the risk of renewed budgetary slippages. Given the importance of fiscal consolidation in the current situation, we join Mrs. Mateos y Lago and other speakers who call for stronger safeguards under the program by transforming some of the fiscal indicative targets into

performance criteria. On the substance of the fiscal program, we would, like other speakers, in particular encourage authorities to reduce dependence on the cascading National Security Levy as soon as possible.

Finally, I note that full implementation of structural reforms will, in the staff's view, need to wait for the economic and political situation to improve. We nonetheless urge the authorities to press ahead in this area in order to put macroeconomic stabilization and economic growth on a more sustainable basis and to improve prospects for a successor arrangement under the PRGF.

The staff's recommendations on public enterprise restructuring, financial sector reform and public administration go in the right direction. Like Mr. Taylor, these reforms should be accompanied by a better-targeted social safety net. There appears to be room for improvement in this area, as suggested by press reports on the costless provision of health care to civil servants. The authorities should give careful consideration to the World Bank's social policy advice.

Mr. Al Azzaz made the following statement:

It is unfortunate that the economic situation in Sri Lanka remains difficult. Despite steady growth and some progress in reform, inflation and unemployment remain high and the economy is still vulnerable to internal and external shocks. The priority now is to strengthen policy implementation, to sustain growth, and to address the structural causes of economic imbalances. In this connection, I am reassured by Mr. Jayatissa's preliminary statement that the authorities are aware of the challenges and are committed to adhere to the program. I, therefore, support the authorities' request for a Stand-By Arrangement.

Fiscal consolidation is central to the authorities' program. Slippage in this area could undermine the stabilization effort. Therefore, it is critical that the targeted reduction in the fiscal deficit be fully achieved. The ongoing efforts to strengthen tax administration and broaden the tax base should help achieve this objective and facilitate the full realization of the benefits of the envisaged measures to enhance efficiency in the tax system.

On the expenditure side, I endorse the emphasis on rationalizing current spending. Here, the authorities determination to contain pressure on the wage bill and maintain the freeze in public sector employment are steps in the right direction. Attaining the medium term fiscal targets also depends on success in reforming the civil service and pension system. Such policies are needed for increased social spending and the investments required to enhance growth prospects.



Increasing the role of the private sector will require continued vigilance in implementing structural reform. In this connection, intensifying the ongoing restructuring and privatization initiatives is critical to raise the economy's growth potential.

Turning to the banking sector, enhancing supervision and prudential regulations should help improve efficiency and competitiveness. In this regard, I welcome the ongoing efforts to improve the supervisory role of the central bank and the measures taken to address inefficiencies of the large state banks. I also welcome the authorities' participation in the Financial Sector Assessment Program.

On monetary and exchange policies, I share the staff's view on the need for a tight monetary stance to bring inflation down, increase reserves, and strengthen confidence. Here, the authorities' effort to study the inflationary process with a view to adopting an inflation targeting framework bode well for strengthening the conduct of monetary policy. I also concur with the authorities' decision to float the rupee. In this connection, I welcome the authorities' intention to further relax the temporary measures that accompanied the float as soon as possible.

With these comments, I wish the authorities success.

Mr. Fidjestøl made the following statement:

Economic performance in Sri Lanka has been rather mixed since the last Article IV consultation. Growth of GDP in 2000 was quite strong at 6 percent, and export performance was even stronger with a growth rate of exports of 14.7 percent in real terms. Despite these rather encouraging numbers, Sri Lanka came close to a foreign exchange crisis in late 2000 when the exchange rate depreciated and inflation increased sharply. This negative turn of economic developments was partly due to external factors such as the rise in oil prices, which contributed to a reduction in the terms of trade of 3 percent. It also reflected domestic developments, as the fiscal deficit increased to 9.75 percent of GDP, more than 2 percent higher than targeted in the original budget. The weak fiscal performance reflected a sharp rise in military spending, which also affected the current account balance, since the increase in budget expenditure mainly reflected increased imports of military hardware.

In this situation, there is clearly a need for a stronger policy framework in order to make Sri Lanka's external situation sustainable. I fully agree that the current imbalances should be tackled primarily through a concerted improvement of the financial position of the public sector. This fiscal tightening has to consist of several elements in order to remove the economic imbalances and lay the foundations for stronger economic performance and

poverty reduction in the medium term. A reduction of military expenditure toward a more normal level is an important part of the needed fiscal consolidation. The budget proposal for 2001 represents a first step in that direction, which hopefully will be followed by further reductions. The high level of military expenditure illustrates that an end to the internal conflict is of vital importance to restoring economic performance.

I also support the staff's views on the need for a more efficient and less distortionary system of indirect taxation, and the change to a system with an automatic pass-through mechanism for oil prices. In this context, the authorities deserve credit for implementing very significant increases in administered prices for oil products in order to contain public expenditure.

I also would like to emphasize the need for restructuring public enterprises, including the implementation of a new pricing structure, to alleviate the burden on the budget and improve the efficiency of public enterprises. Like Mr. Yoshimura, I would also emphasize the importance of privatization that in addition to alleviating pressures on the budget will have a favorable effect on the balance of payments. Furthermore, I support Mr. Nardelli's comments on labor market issues.

I agree with the staff that a tight monetary policy stance should be maintained in order to alleviate pressures on the current account and to raise the level of reserves. While I recognize the improvements that are taking place within the banking sector, I encourage further progress in financial sector supervision and restructuring in order to improve the robustness of the financial sector and to reduce the costs of intermediation. I welcome Sri Lanka's participation in the Financial Sector Assessment Program.

The alternative scenarios in the appendix illustrates that there are significant risks to the program. The development of the internal conflict, the inability of the authorities to implement the fiscal measures required under the program, as well as a more hostile external environment, could all weaken performance. Furthermore, a combination of those downside scenarios cannot be excluded. The scenarios therefore emphasize both the need for a strict implementation of the proposed program and the need to bring the internal conflict to an end.

With these remarks I can support the proposed decision.

Mr. Maciá made the following statement:

The security situation has regained a certain level of stability as several cease-fire initiatives have succeeded since end-2000 under the Norwegian government's peace initiatives. Authorities are now focusing on

steps to strengthen the macroeconomic stance, assure continued growth levels, pursue fiscal consolidation, and step-up the much needed structural reforms.

Growth remained healthy under strong exports, while the overall fiscal deficit has increased affected by wages and security expenditures. Inflation climbed by end-2000, and was induced by a depreciated rate of exchange, high administered prices, and deterioration in the terms of trade. The exchange rate responded to heavy borrowing from public enterprises, and the central bank increased the repo rates and treasury bond yields. This action helped to contain broad money growth. The treasury bills' portfolio increased in the central bank affecting the public debt stock.

Growth over the medium term faces certain risks as exports could be harmed by poor weather and expected lower garment demand from the United States, although the removal of restrictions from the EU could open new opportunities in manufacturing. Inflation is bound to taper off under tight fiscal policy, and the pass-through of energy prices and exchange rate depreciation should contribute to a reduction in consumer demand. In addition, the authorities' monetary program aims to increase net foreign assets, reduce domestic credit growth, and curtail public sector borrowing. Fiscal consolidation objectives will target tax collection, curtail exceptions, change the GST system in 2002, cut expenditure, provide for wage discipline and larger privatization receipts. As authorities prioritize foreign-financed projects allocations, social safety net allocations will increase, and improved targeting will increase the delivery efficiency to the Samurdhi program.

The external sector should improve as export competitiveness impacts the industrial sector growth, tourism receipts and private transfers pick up, and the commitment to cap defense spending tapers imports. As Mr. Jayatissa explained in his detailed preliminary document, large privatization proceeds are expected from sales and concessions of the wheat operation, the insurance sector, and telecommunications, and it is envisaged that the restructuring of the ports, the delayed hydropower undertaking, and other additional smaller projects should increase FDI inflows as well. Notwithstanding, Sri Lanka remains heavily dependent on external donors, IFIs, and the private sector to fulfill the financing gap foreseen in the capital account projections, and we concur with any efforts to frontload the necessary assistance.

Several issues pose major challenges to the authorities. A solution must be sought to the use of the Extended Fund Facility (EFF) as a captive source for financing, and steps to limit the borrowing discretion of government enterprises should enhance fiscal discipline. Authorities must also tackle the closing down of redundant institutions and take restructuring steps while dealing with the potential unemployment impact of this decision. The staff's opinion on this matter would be welcome. As the banking sector and insurance have benefited by the expansion of foreign ownership, and

supervision has also been strengthened, attention must be geared to undertake the inefficiencies of the state-owned banks. Still pending ahead are the civil service reform, the retirement pension system for the private and public sector, and the rigidity of the labor market's legal framework. Lastly, the conflict remains a risk to macroeconomic stability, to growth, to structural reform issues discussed, and to fiscal consolidation as well. To enhance the development drive in Sri Lanka, this chair agrees to the Stand-By Arrangement, and wishes the authorities success.

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

The Bank has been in dialogue with the government of Sri Lanka for some time on private sector development and all aspects of structural reforms. The slowdown in privatization that has taken place over the last two years was in some ways foreseeable. The government was not very well prepared to carry out those structural reforms which are technically difficult, especially as the political environment had become more complex. However, during this time, the Bank has been able to improve its knowledge base considerably regarding various aspects of structural reforms. Analytical studies on poverty have been carried out. An extensive and ongoing dialogue has taken place on privatization covering major sectors, in particular in infrastructure where modern regulatory institutions must be put in place. The Bank recognizes that these reforms are difficult and time consuming. Bank staff are cooperating with the government and are proceeding as fast as possible on the most important elements of Bank support for next year. As Mr. Carter has mentioned, our first priority is to have a private sector development loan ready in fiscal year 2001. A mission is scheduled for May 2001 to discuss these issues. The timing of the implementation of the loan will depend greatly on the authorities. The approach favored by the Bank and the Government is to have a wide array of policies in privatization covering various infrastructure sectors, while allowing the government to decide precisely what projects should be carried out and when they should be carried out.

As Mr. Carter has mentioned, the Bank plans a PRSC in the next fiscal year to accompany a PRGF arrangement. This is possible given that in the next fiscal year the Bank and IMF will be working closely together with the government on a PRSP.

Mr. Jayatissa made the following concluding statement:

I would like to thank Executive Directors for their constructive comments and suggestions made today. I very much appreciate the understanding of the difficult choices that Sri Lanka has to make, and the comments for further economic reforms under very difficult conditions. I thank the staff for the policy advice that they have given to the government.

The authorities are committed to undertake the necessary reforms toward fostering faster, sustainable growth and poverty reduction, while maintaining a stronger and viable balance of payments. The past year was an extremely difficult year, as the government had to contain the challenges posed not only by unfavorable external factors, but also the serious internal threat internationally classified as terrorism. If the country's security situation was not strengthened in 2000, the situation would have been worse, undermining the progress that we have made so far toward economic growth and poverty reduction. The authorities are making a genuine effort to reduce military expenditure, and the staff and the authorities had met in Sri Lanka and to discuss this matter. The authorities have clearly recognized the need to contain military expenditure to the possible minimum and contain the fiscal deficit this year toward a medium-term fiscal consolidation.

The authorities have also undertaken serious structural reforms to improve the private sector participation in the economy. They wish to reinforce and strengthen prevailing market confidence. With this objective, important policy measures with the firm commitment to further reforms have already been put in place. Concerns have been expressed on the risks to the program because of the conflict. Risks associated with the conflict appear to be lower now than compared to the past, in particular because of the Norwegian Initiative to arrive at a negotiated peace settlement to the conflict.

The authorities have taken bold steps in floating the exchange rate and consumer demand for imports as of late has declined. Some Directors have expressed concern that interest rate reduction may be too premature. Yet with an inflation rate of 13 to 21 percent, and a prime lending rate of 23 percent, that amounts to an almost 79 percent real interest rate in Sri Lanka. Some analysts think that monetary policy is too contractionary. I share those analysts perspective on this matter, particularly the heavy cost on the real economy, and possible fiscal burdens. Nonetheless, I will definitely convey to the authorities that Directors did not view this as an appropriate time to relax monetary policy.

On the general approach to Sri Lanka's economic problems, Directors agreed that the short-term stabilization program is appropriate, but that major efforts are needed to strengthen implementation of structural reforms, pension reform, labor market reforms, and continuation of the financial sector strengthening programs.

On program risks, the benchmarks should be made more stringent, I hope the authorities will take serious notice on this point. I will convey this message to them. The authorities will definitely sharpen pursuit of program objectives, with the goal of moving toward a PRGF-supported program as soon as possible. The staff and the authorities have been discussing this issue

of program design for some time. Given the difficult conditions, it was decided that the stabilization program was essential, while firm commitment should be made to embark on further reforms.

On fiscal policy, efforts are already underway to rely more on the GST, and the authorities will do as much as possible based on the discussion they will have with the upcoming FAD mission.

On the structural reforms, the authorities have recently strengthened the structural reform agenda. The World Bank and the Asian Development Bank will be supporting the agenda, along with other bilateral donors. Mr. Yoshimura mentioned that it is essential to invite foreign direct investment not only from the viewpoint of strengthening competitiveness of the textile industry, but also to diversify the export base. In fact, this is already happening, although in the composition of exports, textiles are a very large component. Yet in the composition of total foreign investment, it is not that large at 16 percent of total FDI while 60 percent is allocated to the services sector, including the hotel industry.

It has been discussed whether there should be a staff visit in mid-May 2001 to review the emerging situation and identify any emerging problems. This would allow for precautionary measures necessary to ensure that the program will be implemented as planned. This mission would be welcome and should be approved.

The Acting Chairman (Mr. Sugisaki) said that at the beginning of the discussion, Mrs. Matcos y Lago had carefully analyzed the important aspects of the program, including the fiscal performance criteria and targets, the financing gap, and prospects for privatization proceeds, as well as issues regarding access under the SBA. Some Directors had supported at least some aspects of her intervention, and most of the points had been well answered by the staff. Those who had concerns about the program had come to a better understanding of the various aspects involved. On the specific issue of fiscal indicative targets, such as the primary balance of the budget or fiscal revenues, the staff had explained why those had not been chosen as performance criteria—data on those aspects were not readily available in a timely manner. However, the staff would look into those data to the extent possible, and take account of those data in judging the government's fiscal position. Directors should be assured that those aspects of the data, as well as the fiscal performance criteria, were important aspects of the program. Therefore, while the abstentions of two chairs were respected and would be recorded, it was hoped that, on the occasion of the review—provided that the program was on track—those Directors would reconsider their position and hopefully could be able to join others in supporting the program.

The Acting Chairman made the following summing up of the Article IV consultation discussion:

Executive Directors agreed with the thrust of the staff appraisal. They noted that notwithstanding the effect of the civil conflict on Sri Lanka's economy, robust growth of exports supported by the authorities' efforts to implement sound macroeconomic policies have led to respectable economic growth over the past decade. Against the background of the serious economic difficulties that arose in 2000, the Directors generally welcomed policy adaptations adopted by the authorities, especially the substantial fiscal consolidation, the concerted improvement in the financial position of the public enterprises, and a flexible exchange rate policy. Directors expressed serious concern, however, at the slow pace of reform implementation.

Directors agreed that the fiscal targets for 2001 and 2002 and the underlying revenue and expenditure measures were appropriate. In this context, they considered that the main challenge facing the authorities in the short term was to arrest the severe deterioration in the fiscal accounts that took place in 2000 by putting security-related spending under control and improving revenue collection.

Directors called for strengthening the financial position of the public enterprises. In this regard, they noted that the impact of high oil prices was considerable in 2000, and commended the authorities for significant increases in administered prices. These changes should reverse the operating losses of the Ceylon Petroleum Corporation (CPC) by the end of 2001 and lessen the fiscal cost of other subsidies. Directors welcomed the authorities' commitments to put in place an automatic pass-through mechanism, which would ensure that domestic fuel prices respond to changing world oil prices.

Directors welcomed the authorities' adoption of a fully flexible exchange rate mechanism. They emphasized that the central bank should limit its intervention in the foreign exchange market to dampening volatility, as well as to permit the central bank to build up reserves. In this regard, Directors welcomed the recent relaxation of foreign exchange regulations and urged the authorities to rationalize the remaining regulations in order to reinforce the market determination of the exchange rate.

Directors expressed concern over the increase in inflation in 2000, while noting that this was largely related to exogenous developments. Nevertheless, Directors urged the authorities to maintain tight monetary policy, at least until the fiscal adjustment takes hold, inflation declines, and reserves start to increase. In this context, several Directors cautioned against any premature easing of interest rates. The authorities would also need to ensure that the use of open-market operations is consistent with the monetary

targets. Directors urged the central bank to develop further its reserve money framework with the assistance of MAE.

Looking forward, Directors noted that for Sri Lanka's medium-term viability, the authorities would need to press ahead with an ambitious structural reform agenda. In view of the widespread poverty, Directors expressed the hope that the authorities would design and implement a program to foster sustainable growth and poverty reduction under a program that could be supported by a PRGF arrangement. In this context, Directors urged the authorities to improve the performance of the public sector, and improve the prospects for private sector activity to establish an economic environment conducive to a higher growth path. They noted that the structural reform agenda should be supported by medium-term fiscal consolidation, which would help release resources for more productive private sector activities. Thus, Directors endorsed the government's medium-term objective to reduce the overall deficit to below 5 percent of GDP. Looking ahead to a possible PRGF arrangement, some Directors stressed the critical importance of controlling security-related expenditures and ensuring that they did not crowd out social programs and outlays for poverty alleviation.

Directors recommended that plans be developed to make the civil service pension scheme more affordable, while the treatment of government and nongovernment employees should be unified to increase labor mobility. They called on the authorities to improve the functioning of the labor market by moving ahead with the proposed revision of the procedures for dispute settlement and arbitration. An overhaul of key labor legislation would also allow enterprises greater freedom to determine appropriate staffing levels and thereby facilitate job creation.

Directors emphasized the need to strengthen the financial system and increase its efficiency, and in this context they welcomed the authorities' participation in the joint Bank-Fund Financial Sector Assessment Program (FSAP). They called on the authorities to implement fundamental reform of the state banks without delay, with the government committing public funds only after serious restructuring has taken place.

Directors noted that the authorities have been providing the Fund with key economic statistics on a timely basis that are adequate for program monitoring and macroeconomic surveillance, while urging the authorities to take the remaining necessary steps for subscription to the SDDS.

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



The Acting Chairman made the following points related to Sri Lanka's request for a Stand-By Arrangement:

Directors observed that the authorities had initiated substantial measures to tackle their macroeconomic problems. Noting the financial support for the program from other sources and the encouraging recent developments for reserves and the exchange rate, Directors approved the proposed Stand-By Arrangement.

On the fiscal front, while noting the constraints on raising GST immediately, Directors stressed that this tax is critical for the long-term viability of the tax system and would allow the government to reduce its dependence on the cascading NSL and temporary surcharges. They welcomed the authorities' commitment under the program to reduce NSL significantly and have a compensating increase in the GST in the 2002 budget. Several Directors expressed concern about the level of security-related spending, and urged the authorities to monitor the level of military spending in the future.

More generally, Directors noted that the Sri Lankan adjustment efforts are inevitably subject to risks arising from the conflict and the associated impact on security-related expenditure. In this context, they urged the authorities to undertake the remaining critical structural reforms as soon as possible. This would underpin the broad growth and poverty reduction objectives and could help to attract the envisaged broad financial support.

The Executive Board took the following decision, with two abstentions by Mrs. Mateos y Lago and Ms. Brukoff:

1. The government of Sri Lanka has requested a Stand-By Arrangement in an amount equivalent to SDR 200 million for a period of 14 months from April 20, 2001.
2. The Fund approves the Stand-By Arrangement for Sri Lanka set forth in EBS/01/41, (3/21/01) and decides that purchases may be made under the arrangement, on the condition that the information provided by Sri Lanka on the implementation of the measures specified as prior actions in Table 2 of the Memorandum on Economic and Financial Policies attached to the letter dated March 19, 2001 is accurate.  
(EBS/01/41, 3/21/01)

Decision No. 12473-(01/40), adopted  
April 20, 2001

**DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING**

The following decisions were adopted by the Executive Board without meeting in the period between EBM/01/39 (4/16/01) and EBM/01/40 (4/20/01).

**5. REPORT ON DELAYED COMPLETION OF ARTICLE IV  
CONSULTATIONS AND EXTENSION OF APPROVAL OF EXCHANGE  
MEASURES**

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance Over Exchange Rate Policies," attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board decides that the period for completing the next Article IV consultation with Samoa, Guatemala, Iceland, and Switzerland shall be until the dates indicated in EBD/01/39 for such countries. (EBD/01/39, 4/11/01)

Decision No. 12474-(01/40), adopted  
April 18, 2001

**6. APPROVAL OF MINUTES**

The minutes of Executive Board Meetings 98/76, 98/93, 98/126, 99/86, 99/94, 00/64, 00/68, 00/97, 00/102, 00/112, and 00/122 are approved.

**7. EXECUTIVE BOARD TRAVEL**

Travel by Executive Directors as set forth in EBAM/01/39, Supplement 1 (4/16/01), and EBAM/01/41 (4/16/01) is approved.

APPROVAL: August 9, 2001

SHAILENDRA J. ANJARIA  
Secretary