December 11, 2003
Approval: 12/18/03

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 03/86

10:00 a.m., September 10, 2003

Contents

Executive Board Attendance

H. Köhler, Chairman
S. Sugisaki, Acting Chair
A. Carstens, Acting Chair

Executive Directors	**Alternate Executive Directors**
S.M. Al-Turki	A.S. Al Azzaz
	A. Al Nassar, Temporary
D. Ondo Mañe	L. Rutayisire
I.E. Bennett	C. O'Loghlin
	C. Gust, Temporary
M.J. Callaghan	M. Reddell
	W. Cho, Temporary
F. Zurbrugg	W. Szczuka
	T. Skurzewski, Temporary
K. Bischofberger	C.M. Meissner
	B. Reichenstein, Temporary
P.C. Padoan	H. Vittas
	J. Santos, Temporary
S.M. Indrawati	I. Alowi
	A. Rogers, Temporary
	R.A. Jayatissa
	K. Kanagasabapathy, Temporary
	V. Bhaskar Temporary
W. Kiekens	I. Abel, Temporary
V. Egilsson	B. Andersen
N. Jacklin	M. Lundsager
	J. John, Temporary
P. Duquesne	S. Boitreaud
	S. Boucher, Temporary
	M. Daïri
	S. Rouai, Temporary
	S. Maherzi, Temporary
A.V. Mozhin	A. Lushin
	S. Vtyurina, Temporary
	I. Zakharchenkov, Temporary
L. Martí	M. Beauregard
	M. Mirabal, Temporary
T. Scholar	M.A. Brooke
	P. Williams, Temporary
	R. Steiner
	A. Tombini, Temporary
	A. Maciá, Temporary
I. Usman	A. Atoloye, Temporary
	J. Mafararikwa, Temporary
	O. Kanaan
	G. Shbikat, Temporary
X. Wang	A. Wong, Temporary
J. Kremers	N. Gigineishvili, Temporary
K. Yagi	M. Kitahara

S. Naka, Temporary
C. Pereyra, Temporary
D. Ayala, Temporary
H. Franken, Temporary

S.J. Anjaria, Secretary
B. Esdar, Acting Secretary
A. Linde, Acting Secretary
T. Davidson, Assistant
J. Puig, Assistant
W. Rahman-Garrett, Assistant

Also Present
ECB: J. Wijnholds. IBRD: G. Bauche, Poverty Reduction and Economic Management Network Office; H.T. Dinh, and A. Sayeh, African Regional Office. African Department: A. Bio-Tchané, Director; D. Donovan, Deputy Director; P. Ewenczyk, N. Kirmani, C. Tsangarides, M. Yakadina, M. Yulek. Asia and Pacific Department: L. Molho. European I Department: M.C. Deppler, Director; M. Estavao, H. Faruquee, J. Fernandez-Ansola, M. Garcia-Escribano, A. Hoffmaister, H. Huang, A. Jaeger. External Relations Department: M. Bell, L.M. Fouda, D. Hawley, C. Lotze. Fiscal Affairs Department: M. De Broeck. International Capital Markets Department: W.E. Alexander. Legal Department: W.E. Holder, Deputy General Counsel; C. Ogada. Middle Eastern Department: S. Creane, N. Farhan, M. Goswami, T. Kechichian, A. Mansur. Monetary and Exchange Affairs Department: G. De Nicolo, E. Frydl. Policy Development and Review Department: T. Geithner, Director; M. Allen, Deputy Director; L.J. Lipschitz, Deputy Director; A. Boote, W. Brown, D. Desruelle, M. Fetherston, M. Fisher, M. Guerguil, M. Hadjimichael, K. Hviding, R. Kincaid, K. Langdon, I. Lukonga, J. Rahman. Secretary's Department: L. Hubloue, P. Ramlogan, J. Stotsky. Western Hemisphere Department: R. Cardarelli, A.M. Jul, T. Reif. Office of the Managing Director: V. Read, Personal Assistant; A. Mazarei, S. Tiwari, A. Tweedie. Advisors to Executive Directors: S. Bah, S.A. Bakhache, A. Baukol, C. Duriyaprapan, D. Farelius, M. Fiator, P. Gitton, N. Guetat, A. Ismael, J. Jonas, M. Kruger, F. Manno, J. Milton, T. Miyoshi, P. Nijsse, L. Palei, T. Ross, K. Sakr. Assistants to Executive Directors: M. Abbing, J.G. Borpujari, R. Calderón-Colín, Cao L., H. Fabig, G. Francis, P. Inderbinen, N. Joicey, C. Josz, A. Lanza, B.T. Mamba, M. Marques, M. Martínez, K. Nauphal, M.L. Nikitin, R. N'Sonde, P.R.D. Prasad, L. Rizzotti, T. Segara, O. Steudler, A. Stuart, S. Wolff-Hamacher, J. Zubkova.

1. ANNOUNCEMENT BY MANAGING DIRECTOR

At an informal meeting held on September 9, 2003, the Managing Director informed the Board of the intention of the Deputy Managing Director, Mr. Sugisaki, to relinquish his duties in early 2004.

Length: 45 minutes

The Managing Director made the following statement:

I would like to inform colleagues about Mr. Sugisaki's departure from the Fund early next year. When Shige Sugisaki started his second term in February 2002, he had mentioned to me that he possibly may not serve his full term. Shige has now informed me of his desire to step down as Deputy Managing Director of the Fund—around the beginning of 2004—to return to Japan to be closer to his family. While there will be many opportunities for us to express our appreciation for Shige Sugisaki's service to this institution, I would like to say a few personal words at this time.

Shigemitsu Sugisaki has had an extraordinary career of public service dedicated to the pursuit of sound economic policies in his home country, Japan, in Asia, and—more recently—globally. At the Fund, he has made a remarkable contribution to our work and the effective operation of this institution over the last nine years. He is a man of great integrity and humanity, and I have relied enormously on his advice and support. While Shige's decision to leave early has come as no surprise to me, I very much regret that he is not staying longer because I have benefited greatly from his smooth and steadfast management style even in the most turbulent of times. I am sure that Shige will be sorely missed at the Fund.

The Deputy Managing Director, Mr. Sugisaki, made the following statement:

Thank you so much, Horst, for your very kind words. The reasons you have given for my resignation are all true and correct. My wife and I have been away from home for some nine years, and I thought that it is the right time for us to get reunited with the family, including our very old, ailing mothers.

You have kindly accepted my resignation. I have never cited personal reasons for resignation from any post during my 40 years in the public service. So, I have done this for the first time, and I have agonized about doing so, because I always consider myself a public servant who has put public calling above personal considerations.

In submitting my resignation to the Managing Director, I said that I will leave the Fund with utmost respect for this institution and the strongest possible admiration for its dedication and outstanding work of the staff.

It has been a great privilege to work with you, Horst, with your predecessor, Mr. Camdessus, and with many other colleagues in the management—past and present. Of course, Mr. Carstens is one of those with whom I have worked

.

I would like to express my heartfelt thanks for your guidance, support, and friendship, Horst. I am also extremely grateful to the authorities in the member countries with whom I have had the opportunity to work so closely, to the members of the Executive Board—each one of you—and to the Fund staff, all of whom have contributed to making my experience at the Fund truly rewarding. I would like to express my sincere appreciation, in particular, to each one of you in the Board. You have told me a lot, taught me a lot, and have given me good guidance, good advice, and strong support. I certainly treasure those, and I always have had a very good working and personal relationship with the Board, collectively and individually—at least I believe so from my perspective. The relationship is always very cordial and amicable, even with those with whom we disagree on various issues, as reasonable persons always do.

I was not sure whether I could handle this meeting in an appropriate manner because this is a very emotional occasion for myself. So, this morning I did some preparation for this meeting. I went to the eye doctor and asked him to remove excess liquid from my eyes. You may or may not know that the Secretary's Department always provides me with draft summings up in a large-sized font. This is a minor, secondary reason for my decision.

Again, I thank each one of you for the support you have given to me. Today, there are some other Executive Directors who are not here, including the Dean of the Board, Mr. Mirakhor, but I am sure I will have an occasion to thank each one of them in due course. Thank you very much.

Mr. Mozhin, in his capacity as the Acting Dean, made the following statement:

It is in the absence of our most senior colleagues that I have to assume this responsibility as the Acting Dean of the Board. I will not attempt to make a comprehensive statement, as I am sure all of us will have other opportunities to share our thoughts about Mr. Sugisaki's remarkable record at the Fund. Let me just say that we all know that, throughout this whole lengthy and turbulent period, Mr. Sugisaki has been one of the main pillars of the Fund system. I believe that all of us in the Board have learned to count on his quiet and steady presence, and on his remarkable capability to lead the Board in search

of a reasonable consensus, even on the most divisive issues. I really think that the key reason why Mr. Sugisaki has been so successful in this crucial role is that members of this Board have always had a full trust in his good reason, objectivity, and personal integrity. I have no doubt that such performance has required from Mr. Sugisaki a lot of hard work and a lot of patience.

Throughout his tenure as Deputy Managing Director of the Fund, Mr. Sugisaki has been in charge of a great number of policy initiatives and, as I said, I will not even attempt to cover all of them. But I really think one of the lasting legacies of his great service to the Fund will be in the area of the budgetary process. It is truly remarkable how, in the last couple of years, the budgetary process has improved dramatically. We all know that Mr. Sugisaki has been the main driving force behind this whole effort. It is now our joint obligation to consolidate the progress achieved under his leadership.

Lastly and on a more personal note, I wish to say that, for me, it has always been a great pleasure to communicate with Mr. Sugisaki. We all know him as a real gentleman, and also someone of great personal warmth. Mr. Sugisaki, you will be strongly missed in this Board.

Ms. Jacklin made the following statement:

Mr. Sugisaki, on behalf of my authorities, I want to congratulate you on what has thus far been a very, very distinguished career of public service—and perhaps that career will continue on. To date, you have had quite a remarkable span of successes. We also want to thank you for your steadfast dedication to the interests of the Fund while you have been serving as Deputy Managing Director.

Finally, I want to thank you for your generous spirit, the integrity that we all respect so much, and your good counsel and guidance. I personally regret that I am not going to be able to get you to teach me the secrets of the budget as I had been hoping for in my first round of budget discussions since joining the Fund. But, perhaps I can get you to reveal a few of those secrets before you leave at the end of the year.

Thank you again, and we look forward to working with you in the few months remaining of your tenure here.

Mr. Wang made the following statement:

I heard this news with a shock. I would like to say some words to show my appreciation to Mr. Sugisaki for his excellent work in the Fund. In your capacity of the Deputy Managing Director, you have presented a refined skill in coordinating the work of the Board and in bringing about consensus on important policy issues, including quota reviews and distributions, as well as

on country issues, including many Asian and Pacific countries. You have also made considerable contribution to the budget issues, as Ms. Jacklin and Mr. Mozhin mentioned.

As Deputy Managing Director for Asia, Mr. Sugisaki, you deeply understand the reality and diversity of the Asian countries and support them to choose the appropriate roles in reaching their goals. You have helped strengthen cooperation in that region. Especially after your several visits to China in connection with the Article IV consultations, you have built up a very good relationship with our senior leaders and many governmental officials, which have greatly facilitated the dialogue between my authorities and the Fund. Our chair greatly appreciates your great efforts on that.

Mr. Sugisaki, my authorities will always welcome you to China at your convenience in the future, and I wish you all the best in your new assignment.

Mr. Usman made the following statement:

I am sure there will be another occasion for us to make a more formal intervention to show our appreciation to Mr. Sugisaki for his wonderful service, not only to the institution, but also to the whole membership. In particular, I would like to thank him for his untiring effort to appreciate the problems of developing countries, in particular countries in my own constituency. Two years ago, he visited some of my countries, and my country authorities were very appreciative of his effort to understand their problems. In particular, they were impressed by his patience, humility, and enduring effort to go through the difficult discussions with some of our authorities. Because of his humility, he refused police escorts to some of the places he went to and traveled rough roads in rural areas to go and see things by himself.

Here in the Board, I have always been impressed by his calmness, lack of emotion in trying to reach consensus even in the midst of heated discussions and divisive issues. We will certainly miss him, and my authorities will certainly miss his sympathy, understanding, and untiring effort to help them. I would like to register our appreciation, my authorities' appreciation, to you, Mr. Sugisaki. As they say, once a public servant, always a public servant. I am sure wherever you are, you will continue to defend the cause for which you have stood all of these years. I wish you the very best in your future endeavors, and I wish you well in reuniting with your family.

Mr. Yagi made the following statement:

We learned with great regret Mr. Sugisaki's intention to leave the Fund, although we understand and sympathize with the personal

circumstances leading to his decision. Mr. Sugisaki's presence at the Fund has been of tremendous importance to us as a linchpin in our relations with the Fund. Mr. Sugisaki's presence at the Fund and his sincere approach to the Japanese authorities as a whole contributed significantly to obtaining and increasing public support for the Fund in Japan, from the political and economic circles to academia.

Mr. Sugisaki, your portfolio includes various contentious issues, as mentioned by others, such as the Fund's budget, staff remuneration, personnel, and Fund financing issues, including quotas, not to mention the cafeteria issue. You have always demonstrated the fair, balanced, and sincere chairmanship in dealing with these difficult issues.

Mr. Sugisaki, there are very limited number of Japanese working at the managerial level in international organizations. You are one of those rare Japanese, and actually the first to be a Deputy Managing Director of the Fund. You must have had to overcome various difficulties that all pioneers have to face, but you are the last person to give in to any complaints or anger. You surely deserve some rest after your dedication to the Fund for more than nine years, and to the Japanese Ministry of Finance for 30 years. After some rest, I am sure you will capitalize on the precious and unique experience gained at the Fund as well as that at the Ministry of Finance in your future career, whatever it may be, leading the young generation. Our best wishes to you, Mr. Sugisaki, and to your family.

Mr. Jayatissa made the following statement:

Mr. Sugisaki's sudden decision to resign from the Fund is a surprise to us. I sincerely appreciate all the contributions he made to the Fund and all the support he extended to our constituency. Particularly, I must thank him for helping my own country, Sri Lanka, to get the donors' conference and program organized; his support is very valuable to us. I sincerely hope that he will have a good future in his own country, with his family, and I wish him all the very best.

Mr. Padoan made the following statement:

It is very difficult to react to such news in such a short time. Given the fact that we will have another occasion to thank Mr. Sugisaki for his valuable, long contributions to the Fund, let me react on a personal basis, and on two very brief points. First, as far as his personal contribution to the Fund has been, of the many qualities I will miss, certainly one will stand out, and that is his patience and his high diplomatic skills, which have contributed greatly to the practical implementation of what is one of the Fund's most important features—decision by consensus. This will be missed very much by myself and I am sure by our colleagues as well.

On a more personal basis, I would like to thank you, Mr. Sugisaki, and your wife also on behalf of my wife, for the warm hospitality you have given us here in this country and for making us even more acquainted to the nice hospitality of Japan. I wish you the very best for your future activity and for your life, when you are united with your family in Japan.

Mr. Reddell made the following statement:

I would like to join other Directors in expressing our congratulations to you on a long and distinguished career, both in the Ministry of Finance in Japan and here at the Fund for the last nine years, and to express our appreciation. Your portfolio has included a number of the very small island members that we represent, some of the smallest, but full, members of the Fund. We have appreciated your involvement in the country discussions in that area.

We have all appreciated your general demeanor and the way you have chaired the meetings of the Board and wish you all the best in your retirement back with your family in Japan.

Mr. Bischofberger made the following statement:

Let me join other Directors in saying on a personal note that I regret to learn about Mr. Sugisaki's intention to leave the Fund. As has been indicated, there may be other occasions to pay tribute to his outstanding service. I will note only what I learned from him, the improvement of the budget process, which is one of the things we will remember well after he is gone.

I would like to wish him personally all the best for the future.

Mr. Portugal made the following statement:

I would like to join Directors in starting to pay tribute to Mr. Sugisaki's qualities and contributions to the Fund. As it has been said, we will have other occasions to do so. It is sad that you decided to leave early, but after nine years of hard work and a longer career as a civil servant, we can understand your decision. I would say that I would miss very much your wisdom, your personal integrity, and your patience in building consensus here in the Board on very difficult issues, such as the budget, quotas, and others. I really wish all the best to you and your family in your future career.

Mr. Zoccali made the following statement:

Like other colleagues, I too regret this news. I just wish to add my salute to Mr. Sugisaki for his dedicated and distinguished service to this institution and to his country previously. I would also like to acknowledge his

tireless effort to build consensus on the myriad of issues which he has been entrusted with; his stewardship, principally on budgetary issues, stands out. I would also like to thank him on behalf of our authorities for the generous time he afforded in trying to understand the complex reality and the difficulties that many of the member countries are experiencing, including in particular his close monitoring of one from our constituency. For all of this, we will greatly miss Mr. Sugisaki and wish him the very best in the reunification with his family in Japan.

Mr. Alazzaz made the following statement:

We also want to express our appreciation for your very able and long contributions to the Fund. We wish you all the best.

2. FUND'S POLICY AGENDA—DRAFT REPORT OF MANAGING DIRECTOR TO INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE

Document: Draft Report of the Managing Director to the International Monetary and Financial Committee on the IMF's Policy Agenda (SM/03/310, 9/4/03)

Staff : Geithner and Fetherston, PDR

Length: 1 hour, 30 minutes

The Director of the Policy Development and Review Department (Mr. Geithner) informed Directors that the draft report of the Managing Director to the International Monetary and Financial Committee (IMFC) on the Fund's Policy Agenda circulated to the Board was a preliminary version that had been issued before the summings up of the Board discussions on the PRSP and HIPC Initiative progress reports and on transparency had been finalized. In addition, the language on trade used in the draft did not reflect the initiatives recently outlined by the First Deputy Managing Director. The final version of the report would be updated to reflect those developments. More generally, while the report had not been designed to provide a perfect summary of the relevant summings up, Directors were welcome to suggest changes if they felt that the current draft did not appropriately reflect the Board's discussions on the issues included in the report.

Mr. Daïri made the following statement:

This is a good paper. I congratulate Management and the staff for putting it together. I have a few points of nuance, which do not alter any of the major conclusions from the report.

Perhaps in the last sentence of paragraph 1 there could be some reference to poverty reduction to make it fit better with the following paragraph. Otherwise the focus on private sector-led growth is too strong.

In the second paragraph, I wonder to what extent it may be needed to point to the risk of unwinding of the housing price bubble. There is currently no reference at all, as if the only risk came from equity prices.

Paragraph 7 is an important paragraph, especially as far as the views of developing countries are concerned, as it addresses the important issue of systemic implications of policies in major economies. Unfortunately, there is not much information in this paragraph, especially as compared to paragraph 8 on the stepped-up surveillance of trade policy by the Fund. Perhaps we should be more concrete about what the Fund will do in the surveillance of systemic implications of policies in major countries to make this paragraph more credible.

On CACs, addressed in paragraph 17, there was a reference in the staff paper on CACs to the use of these clauses by a few countries, including in the Middle East, before the Fund started getting involved in this area, and how these issuances, which were quite substantial in amount, went unnoticed by the market. Perhaps we could comment on how this can be reconciled with the importance currently attached to the use of CACs.

There is a need for caution in paragraph 20. The fourth bullet in this paragraph talks about helping low-income countries to facilitate the transition to market-based economies and reduce dependence on aid over the longer term so that they can rely primarily on private sources of financing. We have to reconcile this with the indication in bullet 2 in page 19 on the need to improve the absorption capacity of countries for absorption of aid.

In general, I am of the view that in order to have the right incentive structure, we should not look at countries that are successful in their growth and poverty reduction and think about reducing aid to these countries. On the contrary, private financing and mobilization of domestic resources should be additional to the high level of aid that these countries are enjoying in order to push them into faster growth and poverty reduction.

Still on paragraph 20, the last bullet point when we talk about promoting policies in the rest of the membership that are helpful to low-income countries, I think we should first focus on the need to avoid policies that are harmful to low-income countries.

In the last bullet of paragraph 21, when calling on industrial countries to increase development assistance and facilitate progress in trade negotiations, perhaps we should use a stronger word than “encouraging” to make the message stronger.

In paragraph 23 on options for Fund financing, perhaps we should clarify what we mean by this. I think that we need to look at the financing of

the PRGF and the HIPC in particular, in view of the expected decline in PRGF financing after 2005, the need to meet the MDGs, potential HIPC Initiative countries, new arrears cases, and post-conflict countries.

In paragraph 24, maybe some reference could be made to alternative scenarios under different policy options.

In paragraph 26, when talking about debt sustainability for low-income countries, it may be necessary to indicate that debt sustainability assessments should also give due consideration to the need for poverty reduction and to achieve the MDGs, and also in some cases to the need to familiarize low-income countries with market financing when there is room for such access.

In paragraph 30, some reference to vulnerability of low-income countries to pandemics could be appropriate. This could be part of natural disasters, but this interpretation is not straightforward.

In paragraph 32, there could be some reference to the need to encourage the membership, especially the advanced economies, to work more toward achieving greater stability in the international system and improved long-term growth performance because low-income countries are not only dependent on the level of access to these markets but also on the level of activity in these advanced economies.

In paragraph 38, the characterization of a shift toward low-income or PRGF-supported countries in terms of the use of Fund financial facilities would be misleading if we do not place this into perspective by showing the amounts involved. While the number of low-income countries using Fund facilities might be larger, the amounts of resources involved are much smaller.

In paragraph 46, when talking about making Fund surveillance more effective, we could introduce the idea that members have great confidence in the Fund, because it is not only a matter of following its advice, but also being confident that the advice is sound and appropriate.

Also in paragraph 46, when talking about the need for surveillance to be effective, we should be more outspoken about the important risks faced that can disrupt macroeconomic stability and growth and require corrective measures.

I welcome the indications in paragraph 47 about the need to review program design, an issue that we have often raised in the past.

We have to be careful in not being overly rosy when assessing the progress in HIPC and PRGF in paragraph 48.

Finally, I regret that in paragraph 50 we cannot say more about the issue of voice and representation, given the current status of discussions on this area. We hope that progress can be made in this area going forward.

Mr. Egilsson made the following statement:

I would first like to express my support for the excellent report. While I understand that it is not for the Board to approve the report from the Managing Director to the IMFC, I have some suggestions for improvement.

First, I do not particularly like the use of the word "resilient" in the first paragraph of the report. This terms is already extensively used in Fund jargon: economies have become resilient, banks are resilient, and now exchange rate regimes are also supposed to become more resilient. I wonder whether it is possible to have some more imagination in using Fund jargon.

Second, moving to the discussion on the Fund's role in financial markets in pages 5 and 8, I have the impression that the Fund will need to become more involved in the development of financial markets in member countries. As the recovery takes hold and we enter a new period of growth in the next few years, the role of the Fund should focus on supporting growth by fostering the development of financial markets and strengthening financial market institutions. I wonder whether we could comment on this in the report. There are a few references on pages 5 and 8 to the FSAP reviews and the greater attention to be paid to the ongoing follow-up of the FSAP reviews, but I wonder whether more could be said on prospects for a financial market development agenda to gather more importance in the Fund's work.

Third, there is a reference at the bottom of page 5 to the possibility of exploring ways within existing facilities to provide financial support for members facing balance of payments imbalances arising from trade liberalization. It is worth discussing this issue in the report but, as I indicated in a recent informal Board discussion where the staff referred to the creation of a new policy initiative in the area of trade, my feeling is that the Fund should not be scrambling, just before the Cancún meeting, to come up with a new initiative when its efforts in this area do not really amount to a new initiative. We should be talking about adjustment of existing policies rather than making a big fuss about a new initiative.

In the conclusions in page 21, it is mentioned that an important and difficult challenge in our surveillance effort is to find ways of enhancing the impact of policy recommendations on national economic policies. In this regard, a reference could be made to the need to strengthen communications between the Fund and national legislators, as this would be crucial to enhance the impact of policy recommendations.

Finally, I would appreciate it if I could get some clarification of the thinking behind the statement in paragraph 47 that we must strive to find ways in which our lending instruments can be used proactively to support members that are implementing good policies. Are there any specific thoughts behind this or is it just a general statement?

Ms. Jacklin made the following statement:

This excellent report places our work in the global context, and it balances well the responsibilities of all members to contribute to achieving international financial market stability while promoting global growth. We only have a few suggestions that could be taken into account in reviewing the report.

In Section II.C. on reducing vulnerability, the close monitoring of countries assessed as potentially vulnerable is emphasized. You might consider adding a reference to our focus on how we actually improve our impact on country behavior in order to reduce those vulnerabilities.

As noted by Mr. Geithner, the conclusions of the recent Board discussion on transparency will need to be reflected in paragraph 14 of the report.

Regarding paragraph 16 on crisis resolution, we suggest explaining the new exceptional access procedures because that was a major achievement of the Board during the recent period. Perhaps the report could add part of the summing up describing consultations with the Board and the preparation of a separate report evaluating the case for exceptional access.

In paragraph 17, the progress made in many areas is highlighted. It might be useful to add to the first bullet something about the ongoing work of the Fund to continue to educate issuers in the market about the importance of CACs. Our work is not completely concluded on this, and we think that while there is a lot of discussion on the code, more could be said on the continuing work on CACs. Also, the third bullet of paragraph 17 on the code could be clarified to emphasize that the main working group participants are the issuers and investors. We do not want to mislead readers into thinking that other countries are actually a party to the intended code. I also would like to support Mr. Egilsson's comments on strengthening the section involving the Fund's role in financial markets, including local financial markets. Obviously, we would avoid using the word resilient in additional provisions.

On the organization of the report, a more logical sequence might be to move the section on use of Fund resources section up so that it becomes III and it follows more directly after the section on crisis prevention

The low-income section is very well written. Only a minor suggestion on paragraph 26, fourth bullet. We ought to refer in this bullet to our standard language on "due to exogenous developments."

Mr. Jayatissa made the following statement:

The excellent report of the Managing Director to the IMFC brings out the current issues for the Fund. We particularly appreciate the following aspects of the report: first, the clear presentation of the backdrop to the current economic environment and outlook that calls for appropriate responses from the community, as brought out in paragraphs 1 to 3, and as clearly stated in the concluding section; second, the emphasis on a proactive approach and the identification of five broad objectives clearly stated in paragraph 5; third, the indication that the thrust of surveillance will be evenhanded across the Fund's diverse membership and the focus in particular upon systemic issues and policies of the major economies.

Turning to more specific comments, the effectiveness of the Fund's role as a confidential advisor depends on its success in convincing the membership to adopt sound policies to promote growth on a sustainable basis. This is a cooperative endeavor between the Fund and the authorities. While the market may directly derive benefits out of Fund surveillance, the primary responsibility of Fund surveillance is to the membership and the authorities. The policy steps to strengthen surveillance should recognize these fundamental aspects. In this regard, we invite attention to the last section of paragraph 14, where it is stated that some members have reservations in light of the implications for the domestic political debate. The real issue goes beyond political debate, as it has also to do with market sensitivities. I would appreciate it if this factor could be reflected in this section.

We welcome the importance given to the trade agenda. The primary indication about the financial support of members facing balance of payment imbalances on account of trade liberalization is welcome. Before strengthening technical assistance in this field, it would be useful to have a review on the assistance already provided in this regard.

We also welcome the clear acknowledgment of the useful role played by the Independent Evaluation Office (IEO).

Ms. Indrawati made the following statement:

I only have a few comments on the excellent report. First, on paragraph 14, I would like to support Mr. Jayatissa's comments on transparency. Member countries have reservations not only because of the implications for the domestic political debate, but also because of market sensitivities. There are differences in terms of resilience and the response of markets to new information in different regions.

Second, on paragraph 39, the second bullet refers to the design of Fund-supported programs in low-income countries. The design of macroeconomic stabilization in these countries needs to be improved or refined to reduce the over-optimistic and unrealistic objectives or targets. On the third bullet on capital account crises, in addition to the need to be sufficiently flexible to adapt to rapidly changing circumstances, other important findings of the IEO in this area could be mentioned. I am referring to the contentious choice between ownership and the credibility of the program, and the adequacy of financing support. There is always a difficult choice faced by the Fund in approving a program that enhances the ownership of the country and a program that will enhance credibility. The Fund is currently facing that kind of difficulty.

Finally, perhaps the staff could clarify whether the reference in the last bullet of paragraph 41 to the need to consider additional steps refers only to sub-Saharan constituents or also to other constituents which are under-represented and need enhancing in terms of capacity building and support for their offices.

Mr. Bischofberger made the following statement:

We welcome the Managing Director's report, which is balanced and comprehensive. I have no remarks relating to the substance of the report, but I would like to support Mr. Egilsson's comment on the third bullet point of paragraph 8.

On publication, I am aware of considerable interest from the media in this report. I would welcome if the report were published on the Fund's external web site as soon as possible following its circulation to the members of the IMFC.

Mr. Rutayisire made the following statement:

The first comment we have is a factual correction. On page 24 of the report, Table 2, Mauritius is placed in the column titled FSAP underway. We think this is incorrect because the FSAP review for Mauritius has been completed and was discussed at the Board in July.

Second, with respect to paragraph 32, page 17, bullets 1 and 2 need to be reinforced to show that we strongly support the WTO's efforts to enforce adherence to trade rules. The current language is a little bit compromising.

Third comment, in paragraph 22, page 14, the second bullet starts very negatively and can give the impression that we are contradicting the existence of a role for the Fund in low-income countries. The Fund is providing strong support to these countries, and this should be properly reflected. We would

suggest that the first sentence be dropped, and that the bullet point starts with the second sentence deleting the word "instead."

Mr. Bennett made the following statement:

This is an important report that tries to compress into a relatively few pages the work of the Fund and we would like to congratulate those who put it together for a good job at trying to accomplish that. Just two comments at this stage.

First, I support Mr. Bischofberger's comments about publication. In fact, some thought could be given, perhaps not for this paper because of the time constraints, for compressing it even further into almost a brochure that could be used to convey in a shorthand way the accomplishments of the Fund over the past year. I know that from my own perspective that sort of document developed with our communications people might be quite useful in discussions with NGOs and others in conveying to them in a summary fashion what the Fund is all about and what we have done over the course of the year.

The second comment concerns the Use of Fund Resources. It picks up a point that Mr. Daïri raised. I wonder, having said that we should compress the paper, if we are capturing some of the important shifts that might have occurred in the Use of Fund Resources. While it is true that the number of programs may have declined, the concentration of our resources in fewer program countries has increased. It is important in this era of transparency for the Fund to acknowledge—not in an alarmist way, but simply as a matter of fact—that we are doing a lot more in those countries, and it is a reflection of how we are using our resources.

Mr. Kremers made the following statement:

This is an excellent report. I have only one suggestion to make on paragraph 15 on the contingent credit line (CCL). My impression is that the text on the CCL actually is more open than the discussion we had in the Board. For example, it does not mention the sunset clause and it might raise expectations that are unwarranted. Perhaps that text could be revised.

Mr. Tombini made the following statement:

I join other Directors in praising the quality of the report, and I thank you and the staff for a well-balanced document. I just have a few suggestions.

In paragraph 5, second bullet, the language on promoting improved methods for crisis resolution is too narrow. I would suggest considering an alternative which should be promoting better crisis resolution because not everything that we are discussing are improved methods in this area.

In paragraph 6, there is a reference to the review of Fund surveillance, saying that "it will further consider these and related issues." The phrase immediately before that refers to members that had Fund arrangements. Since the review will not be related just to those members, I suggest saying "other issues" instead of "related issues".

In paragraph 10, bullet 1, I would suggest saying "where appropriate and feasible" in the last phrase referring to contingent liabilities, which currently says, "where appropriate, more detailed modeling of contingent liabilities." It might be appropriate always but sometimes not feasible.

In bullet number 2 in paragraph 10, referring to balance sheet weakness, we would prefer broader language than the reference in parenthesis to particularly large scale mismatches between assets and liabilities, which is related to emerging markets. One alternative would be to suppress the whole content of the parenthesis. The other one would be to expand it and consider also the mismatches in the housing financing industry in advanced economies.

In paragraph 15 there is reference to precautionary arrangements. We were disappointed with the limited coverage of this important issue in a single paragraph. We would like to see if it is possible to expand a little bit on this. One way to do that is to list towards the middle of the paragraph the possible modifications recently considered by the Board.

In paragraph 17, bullet number 1, there is a description of the progress made in introducing collective action clauses in sovereign bonds, and several emerging markets are mentioned. I would suggest that we also mention the names of advanced economies when we say that these have also introduced collective action clauses. In the second bullet of the same paragraph, I wonder if it is possible to suppress the reference to footnote number 12, as this document has not been discussed by the Board. The same applies to footnote number 14. In the last bullet of the same paragraph in page 12, there is a reference to the progress made in achieving a degree of aggregation under a contractual framework, but including contractual provisions that allow for aggregation is not entirely straightforward and their design is still at a experimental stage. We would suggest suppressing the words "entirely" and "still" because otherwise we would give the wrong impression that we are close to a straightforward application of aggregation clauses, which is not the case at this point. Also, to say that it is still rather experimental gives a connotation that at this point I do not think we should be conveying.

My last comment is on the conclusion in paragraph 49, where we say that members must continue with the Fund's assistance to build better institutions and strengthen governance. I would suggest saying that members must continue, including with the Fund's assistance, to build better institutions.

Mr. Duquesne made the following statement:

I found the report useful and balanced. The fact that the report will go public is the main motivation behind most of my comments.

On exceptional access, I agree with Ms. Jacklin that this is an achievement of the last few months. We should not say that there is a clearer policy, but that the involvement of the Board before the conclusion of the program is more standardized and stronger.

On crisis resolution, from the introductory paragraph I got the feeling that the only thing that was requested by the IMFC was work on CACs and the Code of Conduct. The legacy of our SDRM discussion went beyond that. This should be clearer in the introductory paragraph. This would mean keeping references to documents that have not been published, so I would disagree with Mr. Tombini. We need to show that we are working on all these aspects since the last meeting of the IMFC.

I also have the feeling that in paragraph 41 on the Fund's liquidity position, the views across the membership should be described with more balance.

In paragraph 42, three reports of the IEO have been published within the last six months, generating attention from the media. The role of the IEO is not only to support the Executive Board in its governance, but to improve public understanding, so a reference to the role of the IEO in the public sphere would be useful.

Finally, there are two sets of references to cooperation between the Fund and the Bank. One on the AML/CFT and the other one on HIPC. I was wondering if references should not be made to other areas of cooperation with the Bank. The Fund is not alone in the areas of FSAP, trade, conditionality, and voice and representation.

Mr. Callaghan made the following statement:

This is a good report and I will be brief. I will just follow up on a point from Mr. Bennett on this report as a way of relaying the accomplishments of the Fund and telling the public what has been achieved over the past six months. It is perhaps an ambitious approach, but I would welcome an even more powerful report, wherever possible, that can link that progress with meeting actual outcomes and objectives, that is moving beyond just a recounting of the processes, but whenever possible linking it with actually achieving an outcome. There is a little bit of this, for example when describing how progress in PRGF-supported countries is lifting growth in low-income countries.

On the IEO, we should go out of our way to put substance to the point that the Fund is a learning institution and that the IEO is an important initiative in this regard. This is somewhat downplayed in the current draft, for example in paragraph 42 when saying that the Fund has taken the IEO recommendations into consideration and is implementing many of them. It is important to emphasize how much the Fund is listening, learning, and responding to the findings of the IEO.

Finally, on the role of the Fund in low-income countries, Mr. Geithner has made the point a number of times that we are at the start of a process, but this does not come out strongly from the report. Mr. Daïri has already picked up on paragraph 22, which is the next steps. It is not clear what the review of the financing refers to. Again, we need to clearly show that there is a lot more to this process and to outline it a little bit more clearly.

Mr. Padoan made the following statement:

This is a good report, but a number of good suggestions have also been made in the current Board discussion, so allow me to reiterate many of the points made by other Directors.

First, I support Mr. Bischofberger's and Mr. Bennett's suggestions on publication. Mr. Bennett's idea to work out a brochure type of publication is a good suggestion for the External Relations Department to work on.

On language, Mr. Egilsson is right when he says that using the term resilient for exchange rate regimes is perhaps a second or third best. The adequate term should convey the idea that we need exchange rate regimes that are more appropriate to the degree of financial integration of countries, and the term resilient might lend itself to ambiguous interpretations.

On exceptional access clauses, I support Ms. Jacklin and Mr. Duquesne in saying that this is an important achievement in procedures which is being implemented as part of the crisis resolution framework of the Fund, and due attention should be given to this idea in the report. Also what Mr. Bennett says about the attention and concentration of resources is important to justify some of the risks going forward.

On transparency, the wording in paragraph 14 could be revised upon finalization of the relevant summing up. Perhaps the last sentence could be more optimistic about moving forward in a cooperative manner.

Finally, I also support Mr. Duquesne and disagree with Mr. Tombini on giving more rather than less emphasis on SDRM-related issues going forward. Paragraph 12 should not be suppressed. I also agree with Messrs. Duquesne and Callaghan on the fact that more substance would be

appropriate in discussing the IEO. After all, many suggestions came out of those reports and management and staff have reacted, taking on board many of those recommendations, and this is an important part of our work that should be given due emphasis.

Finally, I also agree with Mr. Duquesne that something more should be added on the relationship with the World Bank.

Mr. Tombini clarified that he had not suggested suppressing paragraph 12, but only footnote 12.

Mr. Daïri, commenting on the point made by Mr. Padoan about the IEO, considered that the correct language would be to say that the Board, rather than the staff, had taken the IEO's recommendations.

Mr. Duquesne observed that the documents cited in the footnotes that Mr. Tombini wanted to have deleted had already been produced and issued.

Mr. Kanaan made the following statement:

We join other Directors in praising the thorough and well-balanced report. It appropriately puts the emphasis on several important issues, including the need to strengthen surveillance in systemically and regionally important countries, the importance of improving developing countries' trade access to advanced countries' markets, the importance of the Doha Round, the need to focus and streamline conditionality, as well as promote national ownership of programs.

We have a few comments focused on areas where we think the report would benefit from further clarifications and qualifications.

First, with regard to Box 1 on the need for a fresh perspective, perhaps the box could also note the importance of strengthening existing review procedures for Article IV consultations in program countries, including through an enhanced role for PDR, and thus place into perspective the issue of the experimentation with "alternative modalities" for the conduct of these consultations. There was really no consensus at the Executive Board on the merit of adopting such alternative modalities.

Second, paragraph 27 on technical assistance to the low-income member countries should be more balanced. As it is currently drafted, it emphasizes the provision of those areas of technical assistance that are directly related to economic growth and reaching the MDGs. We think it is important for this section to also cover other important areas of technical assistance. Section D could also be strengthened through a more balanced coverage of key areas of technical assistance and capacity building.

In paragraph 14 on transparency, we join other Directors in emphasizing the need for elaboration on the reasons behind some Directors' reservations with regard to unlimited transparency. Directors expressed on previous occasions concerns about the implications of excessive or unlimited transparency for the candor of staff assessments. In addition to the issue of the importance of the domestic political debates, as noted in the current version of the report, the paragraph should note that there is also a concern that excessive transparency would have an adverse impact on the candor of staff assessments. I agree with other Directors that account should also be taken of the possibility of misinterpretation of staff assessments by market participants.

In Section V entitled "Strengthening the Cooperative Nature of the Fund", readers might be surprised to see that few issues are actually picked up in that section that directly relate to the need to strengthen the cooperative nature of the Fund. This section should emphasize the importance of voluntary participation of member countries in the various Fund initiatives, and stress that the Fund should continue to adopt a cooperative approach with regard to its bilateral relations with members. This may be mentioned in one bullet point in paragraph 41.

Mr. Zurbrügg made the following statement:

I very much like that we have sort of established that this report is a longish report. I remember that in the Board discussion on the draft of the previous report to the IMFC this issue was also discussed. It is a good idea to have a self-contained report as an excellent basis for our ministers. I strongly agree with Mr. Bischofberger and others in terms of publication. I am not sure how far the report can be condensed while still being understandable, but the current draft provides a good overview. I just have a few comments.

On transparency, I regret that this section could not be finalized. I have to say that our procedure since our discussion at the Board on transparency is probably not a model for transparency in itself.

On concentration of Use of Fund Resources, I agree with Mr. Daïri and other Directors that we may be excessively sanguine. I do not know if it is possible to put this in a non-alarmist way when over 90 percent of the Fund's outstanding GRA resources are concentrated in four countries, but in some fashion we have to reflect that in the report.

On CCL, I support Mr. Kremers's point. Also, paragraph 17 describing the efforts on crisis resolution should be more balanced. On the IEO, I strongly support Messrs. Callaghan and Duquesne in terms of giving that paragraph more profile. I understand there is a trade-off between length and content, but we could invest maybe a couple paragraphs more on the IEO.

Mr. Usman made the following statement:

I want to join other Directors in congratulating the Managing Director for a comprehensive and balanced report. The issues I would like to comment on have already been mentioned by other Directors. I would like to support largely the issues raised by Ms. Indrawati, Messrs. Daïri, Jayatissa, Rutayisire and Kanaan.

On the issue of compression or suppression of some sections, the report is comprehensive and brief enough. A follow-on compression would probably make it lose the importance of the message we are trying to convey. Some of the sections need to be a little bit more enhanced to make it more comprehensive, but further compression is not necessary.

On paragraph 14, I want to join other Directors in commenting on the issue on transparency. We were promised a summing up on the question of transparency policy by today. Some wording has been suggested which was circulated to departments, and I hope that will come out and we will have the opportunity to look at what has been agreed. Although we agree largely with what has been discussed, part of our problem in developing countries is the issue of communication. We believe that a period of 60 days would have been more ideal for us than 30 days because it would afford us more time to communicate with our authorities and to get them to respond. Some authorities have to go to the legislature to obtain clearance and be able to give authorization for publication. If 30 days is the consensus we will go along with that, but we would have preferred 60.

On paragraph 41, we need to say more on the issue of participation and what is being done, also in collaboration with the World Bank regarding governance in particular. We have addressed this issue based on a two-pillar approach. We have the administrative proposal and the political aspect of it, which needs to be stressed. We could specify what are the options for shareholders to consider as we say that shareholders are to decide.

I am in favor of publication of this balanced and comprehensive report.

Mr. Yagi made the following statement:

Like previous speakers, we find the report to be well balanced and comprehensive. First, on the style or length of the report, I support comments by Mr. Zurbrügg. In relation to that, we support Mr. Bischofberger's point on the publication and Mr. Callaghan's point on putting more content about the progress made thus far.

We have a few more specific points. We support Ms. Jacklin's point on amplifying the section on exceptional access, and Mr. Bennett's point that current Fund exposure is concentrated on some member countries.

Concerning Mr. Duquesne's point on quotas, we share his views and at the same time understand that this is the report of the Managing Director and we respect his judgment.

Just one specific point about Japan. In page 24 on FSAP participation, Japan's FSAP review was completed by the end of August 2003, so we would hope that this could be updated in the report. If the FSAP review process is thought of in a broader sense of including anti-money laundering or CACs, this is still ongoing, but perhaps we could clarify in a footnote that we are referring to this broader concept of FSAP.

Mr. Kiekens made the following statement:

The report is a piece of remarkable bureaucratic work. I do not speak about that in a pejorative sense. In Turkey the connotation bureaucrat is almost a title of nobility, but it is nonetheless a bureaucratic piece of work. I am somewhat concerned that the Board is giving more attention to your report to the IMFC than to its own report to the Board of Governors. This will be released to the public today so we will see comments on our report in the press tomorrow. As I said last year, we need to see how both reports can match better than they do now.

The report of the Managing Director is superior in a couple of ways. First, it is more up to date, and we should strive in the Board to have a report that is equally up to date. Second, it has a lot of references to our bureaucratic instruments, which are the staff papers. This is totally lacking in the annual report of the Board, and for that reason both reports are complementary. The report of the Managing Director is not political in nature, despite the tone of our current discussion, and I am looking forward to the political report of the Managing Director in his address to the Board of Governors.

I am not going to make many suggestions because the report is a remarkable piece of work, but I am somewhat concerned by suggestions to better applaud our progress with exceptional access at a time when our first case under the new exceptional access procedures is probably not one that we would like to showcase.

On the sunset clause, a remark made by Messrs. Kremers and Zurbrügg, the Board's report is superior because we say exactly what needed to be said about the scheduled expiration of the facility in November 2003.

Lastly, I personally disagree with a sentence in the report of the Managing Director. In the section on data provision, the report indicates that we are continuing to rely principally on the voluntary cooperation of members, but that the Fund has recently taken steps to strengthen the legal framework governing data provision to the Fund, and then follows the footnote to the staff paper. I think that we have weakened our framework. By reading this, I do not think that anybody who is not familiar with the Fund's work understands what has been done, but at least the information is there for those who need it for their work, so again in that sense, the paper is a remarkable piece of bureaucratic work.

Mr. Martí made the following statement:

This is a good report and I would like to congratulate Mr. Geithner and his colleagues for this comprehensive report. I just have a few comments at this stage, trying not to repeat what other Directors have already said.

On the second bullet of paragraph 10, I agree with Mr. Tombini's suggestion to drop the parenthesis in that bullet, although perhaps for different reasons. I am uncomfortable with the parenthesis because it is followed by a footnote with an all-out reference to sterilization. The inclusion of this parenthesis with a detail of one of the situations in which we might have a problem in the financial system because of the use of foreign currency is correct, but it is not all that has to be said. Sterilization can exist and can be a problem even if we have no currency mismatches in balance sheets. Therefore, I think that it would be more appropriate to drop that reference.

On paragraph 15 on CCLs, the language used tends to reflect the discussion in the recent Deputies meeting in London, and I would take issue with the use of this language.

On paragraph 20, while it is difficult to take issue with guiding principles if they are drafted in a sufficiently general way I would like to highlight the fact that some readers, particularly authorities in low-income countries that have been able to achieve a reasonable degree of macroeconomic stability, will be disappointed if there is no mention to the possibility of receiving assistance from the Fund in identifying sources of growth in these countries. The problem is not just macro stability, but what we shall do next. This is currently a real problem in some low-income countries. Fortunately this means they have already done their basic homework.

On paragraph 27 on technical assistance, I would suggest adding a reference to the need for the Fund to take a role in coordinating technical assistance. In trying to set up a few programs of technical assistance in my constituency, we have found out that on those specific issues on which technical assistance was to be provided, member countries had already been

lending assistance on their own bilaterally or sometimes multilaterally. There is a large amount of overlap and lack of coordination in contributions of technical assistance. This is not a big deal, but there is a problem, and the Fund could play a role in trying to put order in all these different and scattered programs of technical assistance, with the aim of increasing the effectiveness of the assistance provided by bilateral and multilateral donors, including the Fund.

Finally, echoing comments from other Directors on the IEO, this is a unit in the Fund that provides information and promotes understanding of the Fund's work. Every institution has one of these units. This is not the message that we want to give about the role of the IEO. In my view, the notion of organic independence is what we should highlight first and foremost. The word objective is probably not the word we need. We need to stress autonomy and independence, as having a unit of self-assessment of the technical work done within the institution is necessary from the point of view of good governance.

Mr. Pereyra made the following statement:

First I would like to thank the Managing Director for an excellent report, and I would just like to make a few points.

We welcome the report's clear-cut stance on the need for a commitment by the membership as a whole to achieve a successful completion of the Doha Round, with the stress on surveillance in countries with trade policies of crucial importance for the world trade system.

We agree with the emphasis on even-handed surveillance across the membership, and I wonder if the need for even-handed treatment can be stressed further in connection with paragraph 10, bullet 1 on debt sustainability assessments, building on the Board's discussion on this area. In connection with this same bullet, I agree with Mr. Tombini's suggestion for modification.

Finally, I would like to support Messrs. Jayatissa, Kanaan and others on the need for further qualification regarding paragraph 14 on transparency.

Mr. Wang made the following statement:

I appreciate that this report is comprehensive and I just have a couple of points to add.

First, more could be said in paragraph 1 on the contribution of emerging markets to global growth, as there is currently only a reference to a renewed recovery in industrial countries led by the United States, with many

emerging market economies making progress in reducing their vulnerability to crises. Emerging market economies, especially in Asia, have had high growth rates for some time now.

Second, I want to support the comments made by Ms. Indrawati, Messrs. Jayatissa, Kanaan and others on transparency. I hope that the long-awaited summing up on transparency will be balanced and adequately reflected in paragraph 14, bullet 3.

Mr. Scholar made the following statement:

This is a good report that will give the IMFC a clear sense of recent developments at the Fund. I had a few comments on the low-income section along the lines of what Mr. Daïri has said, but since Mr. Geithner already said at the beginning of our discussion that this section was to be looked at again to bring it into line with the summings up recently issued, I expect these concerns to be addressed in that process. For the rest, I agree with many, but not all, comments from Directors. Rather than going into a detailed discussion at this stage, I shall leave it to the staff to pull it all together.

Mr. Rutayisire, commenting on the reference to balance sheet weaknesses in page 6, considered that dropping the phrase in brackets would weaken the following sentence, requiring full reediting of the whole section. It would be preferable to maintain the phrase in brackets, because that section dealt with weaknesses in financial crisis, and the phrase in brackets referred to actual developments in that area.

Mr. Mozhin made the following statement:

I am broadly satisfied with the report. I share a number of useful suggestions from Directors, and hope that they can be addressed.

The Chairman observed that there was a clear understanding that the report provided a useful contribution to prepare discussions in the Dubai 2003 Annual Meetings. The useful comments from Directors for improvement and clarification would be considered, although ultimately it should be understood that this was his report to the IMFC and that all suggestions could not be incorporated. There seemed to be broad agreement that, after circulation to the members of the IMFC, the report should be published.

Mr. Kiekens agreed with the proposed publication of the report, in line with the Fund's general policy of publication of reports to the IMFC. On the issue of a possible compression of the report to be used as a brochure or pamphlet on the Fund's work, while management and the External Relations Department could best judge whether this would be a useful tool, perhaps this was not the best use of a report that would soon be out of date as the Board discussions on Fund policies continued. The report would be particularly useful for bureaucratic work, with useful references to papers which might not even be available to the public.

The Secretary (Mr. Anjaria) informed that the report would be made publicly available after circulation to the IMFC and before the IMFC meeting.

The Chairman informed that management would discuss with the External Relations Department the best use of the report for the Fund's external relations activities.

3. EURO AREA POLICIES

Documents: Euro Area Policies (SM/03/278, 8/8/03; Cor. 1, 9/9/03; and Sup. 1, 9/8/03); and Selected Issues (SM/03/292, 8/13/03)

Staff: Deppler and Chadha, EU1; Lipschitz, PDR

Length: 2 hours

Mr. Padoan submitted the following statement:

Italy holds the Presidency of the Eurogroup at present, and my statement expresses the common views of the euro area Member States and the European Community in their respective fields of competence.

The authorities of the euro area Member States welcome the staff's assessment of economic developments and prospects for the euro area. They are in broad agreement with the policy conclusions. In addition to outlining where differences of view appear, this statement will update the Board on recent economic developments and policy actions taken at the European level.

Short-Term Economic Outlook

Economic growth in the euro area has practically stagnated in the first half of 2003, but a recovery is expected to start in the second half of the year. There are encouraging signs in this direction: real disposable income is rising, the quality of corporate balance sheets is gradually being improved, several forward-looking indicators have improved and more optimism is being priced in financial markets. Moreover, there are signs of growth picking up in many parts of the world, including in the United States, which in turn should foster growth in the euro area. For the year as a whole, however, the growth rate in the euro area is most likely to be below earlier expectations as weak economic activity in the first half of the year weighs on the overall result. While GDP growth will be clearly below 1 percent in 2003, it will move towards the potential rate in the course of 2004.

The authorities agree with the Fund that the weakness of economic activity in the euro area reflects a combination of cyclical and structural factors. Growth was dampened by subdued international trade growth, low business and consumer confidence, the aftermath of the stock market bubble

and the related growing debt at firm level in some sectors since the end of the 1990s. More fundamentally, structural rigidities in labour markets as well as insufficient competition in some sectors makes adjustments to shocks more difficult and hampers potential growth.

On the other hand, the factors leading to a pick-up in domestic demand are in place. Monetary and financial conditions are supportive to growth; the profit situation is improving; the stronger euro has helped in bringing inflation down, thereby underpinning real incomes; there are no major macroeconomic imbalances in the euro area; there may well be pent-up consumption demand; and there is room for private savings to decline.

Exchange Rate Developments

The euro area authorities view the rise of the euro over the past two years as beneficial on balance. From a global perspective, when the exchange rates of major currencies move to levels more consistent with fundamentals this is welcome, provided that the movement is orderly. From an internal euro-area perspective, a stronger euro is reducing imported inflation and supports real disposable income. Whilst the appreciation of the euro has meant that profit margins of exporters are under pressure, it should be noted that their competitiveness position is now back to its long-term average. Looking at the recent trend, it seems that overshooting has been avoided so far, so that the stronger euro should over the medium term contribute to a re-balancing of the sources of growth from external to internal channels, and will, on balance, be a positive development both for the euro area and the global economy.

That said, the staff rightly points out that the euro area has borne a disproportionally large share of the burden of adjustment to a lower dollar. We share the staff's view that a more equitable global distribution of any further adjustment burden is both desirable and needed from the point of view of reducing imbalances in the global economy and achieving balanced growth in the major currency regions.

Monetary Policy and the Outlook for Price Stability

We appreciate the conclusion of the IMF staff report that monetary policy has been appropriate in the euro area in the light of its economic conditions, as reflected in the outlook for price stability over the medium term. The assessment of the Governing Council of the ECB of the current outlook for price stability which is based on information from economic analysis and monetary analysis is broadly in line with the analysis contained in the report.

Starting with the economic analysis, economic activity stagnated in the first half of 2003, broadly in line with previous expectations. At the same

time, as also indicated in the report, there is increasing reason to expect that economic activity will recover gradually in the second half of 2003 and strengthen further in 2004. Among the factors expected to support economic growth in the euro area, the low levels of interest rates and, more generally, favourable financing conditions should be highlighted. In line with the report, the ECB too assesses that the balance of risks to this outlook is tilted to the downside, although risks may have declined recently.

Turning to the outlook for prices, developments in food and oil prices may contribute to some temporary and limited volatility in inflation rates over the next few months. Beyond the short term, the outlook continues to be favourable. Annual inflation rates are expected to fall in 2004 and remain below 2 percent. In addition to base effects, further dampening effects stemming from the pass-through of the past appreciation of the euro are expected. Moreover, the gradual economic recovery should be accompanied by moderate wage developments and price setting behaviour, and is not therefore expected to contribute to price pressures. At the same time, the ECB is of the view that there is currently no risk of deflation in the euro area.

As regards the monetary analysis, monetary growth remained strong and there is significantly more liquidity available in the euro area than needed to finance non-inflationary growth. The low level of interest rates all along the maturity spectrum has contributed to a high demand for liquid assets, as well as to a stabilisation of credit growth in spite of the weak economic activity. Although a large part of the excess liquidity in the euro area has been caused by portfolio shifts, the ample liquidity needs to be closely monitored. In view of the current economic situation, excess liquidity is not likely to translate into inflationary pressures at present. However, if it were to persist at the time of a significant strengthening of economic activity, it could cause inflationary pressures to build up over the medium term.

All in all, cross-checking the information from the two pillars points to a favourable outlook for price stability over the medium term. Reflecting this assessment, the Governing Council of the ECB decided at its meeting on July 31, 2003 that the current monetary policy stance is appropriate. The ECB will continue to monitor carefully all factors that might affect this assessment and will continue to conduct monetary policy with the aim to maintain price stability, in accordance with its mandate and following its monetary policy strategy.

The ECB appreciates the staff's reaction to the clarification of May 2003 regarding the monetary policy strategy. In particular, the staff has highlighted that the clarification of the definition of price stability has dispelled misunderstandings that might have occurred in the past. The ECB notes the staff's agreement that its definition of price stability provides a sufficient safety margin to avert the risk of deflation and is also capable of

addressing the implications of inflation differentials within the euro area. Regarding the two-pillar framework, the ECB welcomes the Fund staff's understanding that monetary analysis is used to assess medium to long-term trends in inflation as a means of cross-checking the short to medium-term indications coming from economic analysis.

Fiscal Policies

The euro area authorities broadly agree with the staff's view on the key elements of the fiscal policy framework, notably as regards the importance of clear fiscal rules based on a target on the budget balance (a flow), while at the same time taking account of public debt levels (a stock). We also agree that more generally longer run and cyclical considerations have to be balanced. The increased emphasis on the long-term sustainability of public finances is also welcome as well as the link between budgetary consolidation and supportive structural reform.

The latest available information suggests that budgetary outcomes in many countries of the euro area will fall short of the targets in 2003, implying a continued deterioration of public finances. This strengthens the call for a strict monitoring of budgetary developments and application of the common fiscal rules. In implementing the Stability and Growth Pact, the impact of the economic cycle on budgetary positions has been taken explicitly into account, with a focus on cyclically-adjusted budgetary developments. However, the 3 percent reference value of the Maastricht Treaty remains a "hard ceiling" not to be breached. Those Member States that breached it have been put under the excessive deficit procedure (i.e. Portugal, Germany and France), which foresees the implementation of a credible consolidation path.

The authorities agree that automatic stabilisers play an important role in cushioning the slowdown. For Member States that have not yet reached a balanced position in cyclically-adjusted terms, this should be done around a consolidation path of the cyclically-adjusted deficit of at least 0.5 a percent of GDP per year, and provided the 3 percent limit is not breached. Those Member States in excessive deficit should correct it no later than the year following its identification in conformity with the Treaty and the SAP provisions which provides for some flexibility.

The euro area authorities agree with the staff on the need for more forward-looking policies to improve the quality and sustainability of public finances. For instance, short-term one-off measures should not be used to put off necessary structural reforms. While the euro area authorities agree with the staff on the importance of a durable achievement of long-run goals, we consider that achieving consolidation rather than postponing it is the appropriate way to ensure sound and sustainable public finances.

Structural Reform

The euro area authorities broadly concur with the staff's assessment on the need for structural reforms to step up growth potential. While the area's growth performance is similar to that of the United States in per capita terms, there is considerable scope for making better use of labour resources – which is in itself important for raising social cohesion and growth potential, as well as for the functioning of EMU and the sustainability of public finances. We must therefore ensure that the momentum of reforms does not slow just after the benefits of earlier reforms and wage moderation began to manifest themselves in the years preceding the present downturn, notably in the form of reduced structural unemployment and increased labour force participation. This structural improvement is an important part of the explanation for why the impact of the current downturn on employment has been and remains relatively soft, compared to previous cycles.

The slow recovery however shows that structural reforms should go forward: in this respect, one should note that significant reforms have been initiated recently, including on pension systems in some of the large Member States (and contrary to what is said in paragraphs 12 and 50, structural reform has not been moved off the euro policy agenda). Steps have also been taken to strengthen the coordination of structural reforms at euro level, and we welcome the positive assessment by the staff on these steps. Of course, there is a considerable scope for further progress, and it is essential now that the agreed reform agenda is fully implemented and, as the staff notes, that this new spirit of reform will be sustained long into the future. Certainly, immediate, substantial and sustained progress, particularly on labour market reforms, will be required to maintain confidence in the Lisbon agenda of rising employment rates and improved competitiveness and dynamism more generally. Reform in product markets and measures to increase research and innovation are also main components of the Em's structural reform agenda. There is in particular a need to increase competition, integration in the network industries and to open up public procurement to greater competition and to raise R&D to the EU's target of 3 percent of GDP. On the positive side, recent progress in reforming the aviation, energy and railway should be noted as well.

With regard to financial markets, the staff report notes that there has been further progress in creating a single financial market. Eighty per cent of the original measures of the Financial Services Action Plan (FSAP) have now been completed. Important agreements have been reached in 2003 on directives on insider trading and market manipulation, pension funds, company law, prospectuses and the taxation of savings income. However, there are still important measures pending (e.g. the directives on takeovers, investment services and transparency obligations for securities issuers). With the 2005 deadline in sight, the Commission is currently finalizing the last set

of legislative proposals (which will include capital adequacy, insurance solvency and reinsurance supervision). Consistent transposition and implementation of the FSAP will be facilitated by the extension of the four-level "Lamfalussy framework" for securities markets to banking, insurance and conglomerates. The new arrangements will speed up the legislative process and increase its transparency.

In response to concerns regarding corporate governance and statutory audit, the Commission published two communications on May 21, 2003. The communication on corporate governance includes an action plan, covering key issues such as the disclosure by companies of their governance structures and practices, the reinforcement of shareholder rights, the role of non-executives or supervisory directors, the quality of corporate reporting, and the coordination of Member States' efforts in the area of corporate governance. On statutory audit, important short-term priorities are the incorporation of the principles on auditor independence in a Directive, and the strengthening of public oversight of the audit profession through European coordination.

Trade Issues

The Doha Development Agenda (DDA) is currently the EU's number one trade policy priority. Half way through the scheduled negotiations, the Cancún Ministerial meeting of all WTO Members will be a key staging post of the Round. The EU's objective for Cancún is to achieve meaningful progress in the DDA negotiations, which must: (1) address all DDA issues and reflect the interests of all WTO members, (2) better integrate developing countries in world trade, and (3) make a significant contribution to sustainable development. In light of the current state of the international economy, the EU considers the conclusion of the DDA to be particularly important in order to boost global economic growth and development opportunities.

In order to re-launch the agricultural negotiations, the EU and the United States in August presented a joint framework paper. It focuses on domestic support, market access and export competition. Moreover, the recently agreed reform of the European Common Agricultural Policy, designed to enhance the efficiency of the EU's agricultural market, is a significant contribution to correct trade distortions. Its positive effects will amplify as Member States are expected to introduce significant de-coupling of subsidies from levels of production. Furthermore, it should be recalled that a significant proportion of the EU's agricultural imports from developing countries, and almost all from least-developed countries, are duty free thanks to existing EU import preferences for these countries.

The EU, the United States, and Canada have also tabled in the WTO a joint paper to facilitate negotiations on market access—tariffs and non-tariff barriers—for industrial goods. The paper proposes ambitious tariff cuts and

the reduction of differences in tariff rates across WTO Members. This approach includes measures for granting developing countries special and differential treatment, as well as flexibility to manage their tariffs on the basis of their economic needs. In particular, the joint paper proposes a system of "credits" that allows developing countries to cut their tariff less than developed countries would do, when justified by their economic situation. Additional flexibility should also be granted to the poorest developing countries.

Mr. Portugal and Mr. Steiner submitted the following statement:

We would like to thank the staff for a well-written set of papers. Growth in the euro area has come to a virtual standstill since the last quarter of 2002. Even though household consumption has held its ground, investment and net exports have been declining. The positive impetus stemming from rising real wages and widening fiscal deficits has been all but compensated by the appreciation of the currency and by a significant slowdown in corporate expenditure following the borrowing and spending binge that occurred during the equity market bubble.

Similarly to their counterparts in the United States, corporations in the euro area significantly reduced their financing gaps during the recent episode of sharp contraction in investment. This positive development has not prevented leverage in the euro area from continuing to increase, something that is no longer being observed in the case of the United States. According to the staff, since euro area corporations rely heavily on bank loans rather than on debt securities, financial systems in Europe have been more tolerant of the slow pace of corporate adjustments. We wonder whether this enhanced forbearance, which probably has negative short-term implications on the valuation of banking stocks, might also have adverse consequences on the long-term health of the corporate sector itself. Might it not be the case that euro area corporations are being treated too leniently in spite of the recent excesses? Are needed corporate adjustments being postponed beyond what would be desirable?

We concur with the staff that the recent appreciation of the euro, while being a welcome development from a medium-term multilateral point of view, is also detracting from the area's short-term prospects. Furthermore, we also agree that there is support for the claim that the euro has borne more than its fair share of the recent dollar depreciation. In effective terms, the euro has risen more than what the dollar has fallen. Since most assessments point to the fact that the dollar remains strongly overvalued—by as much as 20 percent according to the recent United States Article IV consultation—one can only hope that any future realignment of the dollar is not accomplished through a further strengthening of the euro. If anything, this observation points to the need for a more accommodative monetary policy stance in the euro area. In

that regard, we are not entirely persuaded by para.13, where the staff labels as "exogenous" the appreciation of the euro and the reduction in external demand.

Also on monetary policy, we welcome recent actions by the ECB, clarifying its intentions regarding "price stability" and the role of the money pillar. Regarding the former, we welcome the fact that not only the definition of price stability has been made clear, but also that the point target is close to 2 percent, rather than to zero. This is a most welcome move because the risks of deflation in some of the larger countries require an accommodative monetary policy stance that would not be likely if the relatively higher rates of inflation of the faster-growing smaller countries—and of future new members for that matter—were to be considered unacceptably high.

The area's long-term perspectives are heavily dependent on demographic developments and on the likely evolution of the labor force. Population aging and policies that deter the utilization of human resources could conceivably cut in half the region's potential output growth in a matter of two decades (Box 2). While not much can be done about aging, structural changes could of course be introduced in order to enhance labor market participation. Unfortunately, and as the staff rightly points out, politically challenging reforms had until recently moved off the agenda, particularly in the larger countries. The very recent renewal of the reform impulse in some of the more systemically important countries is a most welcome development, which we hope will be sustained in the future.

Regarding fiscal policy, we note that while there was broad agreement between the staff and the authorities regarding long-term policy requirements, divergent views were expressed with respect to actions required in the short term. In no region in the world are the links between population aging and fiscal policy as evident as in the case of the euro area. Overly generous benefits financed with highly distortionary labor taxes create disincentives for people to work and, as population ages, threatens fiscal sustainability. A recent European Commission paper quoted by the staff supports the claim that fiscal adjustments are more growth-friendly when they are expenditure-based, rather than based on increasing taxes. Improving intergenerational equity, reducing distortions in the labor market, and addressing issues of fiscal sustainability all point to the need to reduce the very generous benefits currently offered to pensioners. As the staff correctly points out in paragraph 45, this is more easily said than done, particularly given the fact that older voters will be able to form an electoral majority in several countries at a time when the curtailment in pension benefits would be phased-in. We fully concur with the staff that the time for action is running out fast.

In a very interesting chapter of the Selected Issues paper, the staff points to the need for an early buildup of privately funded pension schemes in

order to compensate for any future cutbacks in public pension benefits. Of course, during the transition period contributions are diverted from the public to the private funds, leading, ceteris paribus, to higher deficits in the public system. In classifying this reform strategy as "SGP-unfriendly", the staff is highlighting a very fundamental point: adherence to strict, albeit arbitrary, fiscal definitions may very well remove incentives to carry out important and useful structural reforms. This dilemma is, of course, prevalent in many other countries that have undertaken total or partial privatization of their pension schemes. One can easily imagine that a more sensible accounting framework would adequately differentiate between that part of a fiscal deficit that is the result of the transitional period of a pension privatization program and that part which is not. This is relevant in the context of the SGP as well as in Fund surveillance exercises and in the establishment of fiscal targets in Fund-supported programs.

Unfortunately, concerns regarding the area's fiscal stance are not restricted to medium- and long-term issues associated with aging. The staff persuasively argues that in the region's three largest economies, fiscal policy has been highly pro-cyclical in the recent past, with important expansions at the height of the recent boom prompting contractionary policies during the economic downturn.

The recent timid progress in correcting a few of the most prominent distortions embedded in the Common Agricultural Policy (CAP) does not lend to much optimism regarding the euro area's contribution to disentangling the many obstacles currently affecting the Doha Development Agenda. After all, decoupling of subsidies from production levels will only be limited to certain sectors, no progress has been achieved regarding market access, and the EU's proposal to the WTO in relation to the reduction in tariffs is extremely timid. If recent events do not offer grounds for optimism, the future does not look promising either, with enlargement in 2004 probably making changes to the CAP even more difficult.

The euro area faces important challenges ahead, which may well be compounded by enlargement. Unless a major overhaul is introduced in its very inflexible labor laws and over-generous pension schemes, the prospects for medium-term growth and fiscal consolidation in the major economies of the euro area are poor. Were this scenario to come about together with a further appreciation of the euro, then the situation could become particularly unsettling. The euro area has a long way to go in terms of structural reforms, including enhanced product and labor market flexibility and a more open and less distorted trade regime. In recent months, some reform impetus seems to have emerged, one which we certainly hope can gain additional momentum in the challenging months ahead.

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

Key Points

We see a well-established commitment of the ECB to fight against inflationary pressures, but we have some doubts on the credibility of its commitment to adjust the monetary policy to prevent the risk of deflation.

While we value the ECB's acknowledgement that its inflation goal needed to be clarified, the one that has been selected seems to us far from reassuring.

The likelihood of a German-led deflation in Europe has not dissipated. To fend off deflationary pressures, an effective communication of the ECB's "accommodative bent" needs to go hand in hand with policy actions.

The fiscal policy should gradually adjust towards longer-term goals, allowing automatic stabilizers to operate so as to avoid amplifying the cyclical slow-down. At the same time, monetary policy should be the cornerstone of demand management policies.

We share the staff's disappointment with the overall record of implementation of the Lisbon agenda, especially regarding the overall deterioration of labor markets.

Progress in trade liberalization in European countries hinges critically on the liberalization of agricultural commodities and the elimination of subsidies and other trade barriers in industrialized countries to exports from developing countries.

The staff should be commended for a set of focused papers, which make a thorough review of the euro area policies in the context of the 2003 Article IV consultations for this group of countries. In particular, we value the interesting research topics presented in the Selected Issues papers. We recognize that the preparation of these reports is an especially difficult task, since it needs to strike a delicate balance. On one hand, the main goal is to provide an independent assessment of the demand management and structural reform policies of a large region that is a key component of the global economy. On the other hand, a report that is either too critical or too prescriptive may perhaps be perceived as excessively intrusive. Even though the latter is always a risk with the Fund's work, but the staff has produced a balanced report. At the same time, we see some room for improvement in the clarity of the message. We will focus our statement on highlighting some areas in which, in our view, the staff's appraisal could be better aligned with the evidence provided throughout the document, and hence where further

insights could improve the communication of the message that follows from this discussion.

We think that the short term economic outlook contained both in the staff report and in Mr. Padoan's comprehensive statement might be somewhat optimistic, especially when assuming that the growth rate of economic activity "will move towards the potential rate in the course of 2004". It seems that much of this optimism is based on some forward-looking indicators (including financial prices). To this end, we would like to ask the staff whether there is more robust evidence to expect such a pick-up.

One of the areas in which we have difficulties on reconciling the staff's appraisal with the evidence is monetary policy. The headline in paragraph 53 states that "Monetary policy has done well and established its credibility." Below, in the same paragraph, it is stated that "The ECB's clarification of its inflation objective as 'below but close to 2 percent substantially reduces the scope for misinterpreting its objective and provides a buffer against shocks that could lead to area-wide deflation and provide scope for inflation differentials across countries." In this regard, we would like to provide the following comments.

While we see a well-established track record regarding the commitment to fight against inflationary pressures, we have some doubts about the credibility of the commitment to adjust monetary policy as fast as necessary to prevent the risk of widespread deflation.

This brings us to whether the ECB's inflationary goal is good enough for providing a buffer against shocks that could lead to area-wide deflation, or at least to the outbreak of deflation in some countries, given the required scope for inflation differentials across its membership. While we value that the ECB has finally restated its inflationary objective to "below but close to 2 percent," we are not convinced that under this common objective deflation can be prevented in some countries of the union. There is large heterogeneity among euro area countries, with some of them displaying high and persistent inflation, while others showing signs of substantial deflationary pressures. In such a context, a symmetric inflation target within a target band centered at 2 percent is probably more appropriate. Staff comments would be appreciated.

Regretfully, the reports do not provide sufficient information on the alignment of inflation expectations to the 2 percent threshold, a natural test for judging the credibility of monetary policy. The closest substitute we could find was the pricing intentions of manufacturers, which are indeed negative. Among the devices used to assess the ECB's policy reaction are the standard Taylor rule yardsticks, which show that policy rates are well below the mechanical outcome. In our view, this is an excellent illustration for Mr. Greenspan's argument that real-world monetary policy is about managing

risks that are difficult to quantify. But just as any other econometric model, Taylor rules are based on historical relationships, which are probably not very enlightening to provide an adequate assessment in the presence of significant new risks going forward. Hence, the art of monetary policy requires a much more thorough understanding of the environment, including a global, regional, and local perspective.

The report recognizes that the risk of deflation would be much more severe if the continued slowdown were to turn into a severe recession, or were the euro to appreciate rapidly. On one hand, countries like Germany, Italy, and the Netherlands are already technically in recession, with particularly uncertain prospects for Germany, the largest euro area economy. On the other hand, as stated in the conclusions of the Selected Issues paper on exchange rate pass-through, "the exchange rate adjustment required to achieve a moderate degree of external adjustment may be substantial in the absence of adjustment in other variables". Taking into account these two considerations, it is not clear to us that the likelihood of a German-led deflation in Europe has dissipated. Consequently, in order to timely fend off any deflationary pressures, the ECB's "accommodative bent" needs to go together with actual policy actions.

On fiscal issues, we have less difficulty in accepting that fiscal policies have fared less well. Still, we find that such a rather soft claim needs to be reconciled with the acknowledgement that the fiscal framework has not worked well for the largest three economies, and that the consequent need for consolidation efforts in an environment of weakness has hurt confidence. To this end, while automatic stabilizers should be allowed to operate in order to avoid amplifying potential recessionary dynamics, monetary policy should be the cornerstone of demand management policies, so as to provide enough room for fiscal policy to gradually adjust towards longer-term goals, including those derived from the large aging population shock. Furthermore, a more accommodative stance of monetary policy would also be helpful in boosting domestic aggregate demand within the euro-area, therefore contributing to the effectiveness of the currency realignment in solving the global imbalances in the current account. By so doing, the risk of a substantial further appreciation of the euro-depreciation of the dollar and associated recessionary and deflationary effects are moderated.

As stressed by the staff, while short-run flexibility requires long-run credibility, it also requires an adequate framework, and it remains a matter of debate whether the SGP is the right one. The staff suggests that complementing the current fiscal framework with credible multi-year commitments—including discretionary fiscal policy actions to achieve a 0.5 percent of GDP a year of structural consolidation measures on a cumulative basis for countries with weak underlying positions—would foster sustainability and create the room for flexibility over time. We think that

while it seems helpful to accommodate the SGP within a more forward-looking approach, it might be worth exploring an alternative and perhaps more adequate fiscal framework in the context of a monetary union. For example, we think it would be possible to apply a cyclically adjusted balance approach, provided that estimates of potential output for each member country are given by the Commission through an independent procedure, which is at the same time coherent with a target balance for the whole euro area. We wonder if this might be already contained within the conclusion of the ECOFIN endorsed by the European Council in March 2003 on the use of cyclically adjusted balances and the SGP. Perhaps the staff could further comment on this issue.

On structural policies, we praise the clarity of the message that loosing the exchange rate as an adjustment mechanism within a monetary union imposes a further requirement of flexibility in goods and labor markets. Moreover, the recent appreciation of the euro, which undermines the possibilities of an export-led recovery, adds pressure for such type of competitiveness-enhancing measures. To this end, we share the staff's disappointment with the overall record of implementation of the Lisbon agenda, especially regarding the overall deterioration of labor markets. On other structural issues, the sizable demographic shock could severely impact retirement incomes, calling for urgent measures to prevent a heavy burden on growth. We sympathize with the staff's suggestion to develop a complementary private pension pillar. There is enough experience accumulated in different countries to judge the benefits of a partially funded pension system, as well as to give hints for an adequate model for the euro area countries. Finally, on corporate and financial issues, we hold similar questions to those raised by Mr. Portugal and Mr. Steiner on paragraph 2 of their statement.

On trade policy, progress in trade liberalization in European countries hinges critically on the liberalization of agricultural commodities and the elimination of subsidies and other trade barriers in industrialized countries to exports from developing countries. Hence, we concur with the staff that the implementation of a trade liberalization process under the Doha Round that deals effectively with the issue of agricultural products, is of central importance for developing countries. The recent negotiations by the U.S. and European authorities, prior to the forthcoming Ministerial Meetings in Cancún, are encouraging, and we hope that this meeting will yield concrete results, contributing with a positive signal to the global economy.

To conclude, while these reports provide an important step forward, the need for further reinforcements of the Fund's approach to surveillance over the major industrial economies ought to be underscored.

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

We thank the staff for its candid and comprehensive regional surveillance report on euro area policies and a well researched selected issues paper. The wider coverage of policies, more comprehensive discussion bringing out in particular the trade-offs between the short-term and the medium term policy choices and the thrust of suggestion from the staff for a forward-looking approach for the area, all strengthen the process of regional surveillance to a significant extent. We broadly concur with the staff appraisal and its policy recommendations and therefore we limit our statement to a few observations.

The relatively weak performance of the area should be attributed to both the challenges posed by the unification and the impact of the global slowdown following the bursting of the equity price bubbles. Looking forward, the area is recovering but reaching a sustained growth path will require intensification of structural reforms in labor and product markets. It is encouraging to note from the staff appraisal that the realization of structural reforms has intensified and been demonstrated by many countries.

The turnaround in investment spending is a prerequisite for recovery. One downside risk to this is the corporate balance sheet adjustments. In addition, reforms in auditing and accounting practices and improvements in corporate governance practices are equally important. It would be useful if the staff elaborates on the policy measures taken in the area to strengthen corporate governance practices including accounting standards.

The implementation of monetary policy in the euro area, as we mentioned at the time of the last discussion is adequately transparent. As it turned out, the staff has acknowledged that the policy has done well and established its credibility. The clarification by the European Central Bank about the inflation objective was adequate to provide a clear anchor for longer run inflationary expectations. The two pillar approach also worked well. This underscores the need for the staff to adopt a similar approach in bilateral surveillance recognizing in a flexible manner the choice of authorities and their preferences in respect of monetary anchor and the use of the appropriate mix of policy instruments. We concur with the staff that the ECB needs to guard against downside risks to inflation and that ECB needs to maintain an accommodative stance until there is sufficient indication that upturn in domestic demand would be self-sustained.

In regard to fiscal policy, the euro area faces the serious dilemma of balancing between the short run and long term goals. The problem is compounded by the need for pension reforms in the face of the ageing population shock. Given the utmost importance for the fiscal policy to be a complementary support to accommodative monetary policy, we reiterate our

view that the Stability and Growth Pact should be interpreted in a flexible manner so that the countries have the leeway to allow the automatic stabilizers to work fully in the present downward cycle. We nevertheless concur with the staff that the medium-term fiscal framework should address long-term stability issues more clearly and fully.

As in the case of a fiscal policy, the forward-looking approach applies to structural reforms. In this context, it is encouraging to note that the reform process in the larger countries has been revived and the progress is even beyond the earlier expectations. The steps taken by the Commission to toughen the surveillance in this regard is welcome.

We endorse the staff view that the trade policy in particular relating to agriculture falls short of fully correcting trade distortions. It is encouraging to note that the enlargement of the European Union will provide impetus to trade integration and its impact on third country trade and investment is likely to be limited.

We wish the euro area authorities success in their policy endeavors.

Mr. Reddell submitted the following statement:

Key Points

The report usefully highlights just how similar the experiences of the euro area and the United States have been in recent years. Europe has avoided some of the imbalances seen elsewhere, but at present indications of a pick-up in economic activity are still more tentative.

Given the very real current pressures on the Stability and Growth Pact, we were disappointed not to see more in-depth analysis of the issues around the choice of a workable long-term fiscal rule.

Surveillance of the euro area needs to give greater focus to the unique challenges of making a monetary union among developed sovereign nations work well, and to what is required to ensure that the union remains the sensible exchange rate regime for its members. Enlargement will heighten the importance of this sort of analysis.

Economic activity has been weak in the euro area countries over the past couple of years, reflecting the aftermath of the global equity market and investment cycle of the late 1990s. In this respect, and unsurprisingly in an increasingly interconnected world, the euro area has shared much of the experience of the United States—although, as the WEO reminds us, in the United States the negative output gap has been even larger and the scale of policy stimulus even greater. Moreover, as the papers in front of us today

helpfully highlight, the period of economic weakness came after 10 years of growth in which, on a per capita basis, the euro area matched or even exceeded the economic performance of the United States.

Imbalances are also a common theme—for example, total private sector indebtedness rose by 28 percentage points of GDP in both the euro area and the United States between 1995 and 2002, with the corporate sector relatively more leveraged in the euro area, and the household sector more highly leveraged in the United States. But the euro area has avoided a rapidly rising dependence on foreign capital, and has also avoided the magnitude of the widening in the structural fiscal deficit seen in the United States in recent years. A severe imbalance in the exchange rate between the euro and the U.S. dollar has substantially corrected in the past 12–18 months (but perhaps remains vulnerable to an overshoot in the other direction).

The region, as a whole, has performed very well—even if, as is almost inevitable, the application of a single interest rate to the entire region means that some regions can find themselves facing real interest rates materially higher, and some materially lower, than they would if each country was setting policy on a national basis. The distinction still matters because labor is typically not highly mobile across national borders, because allegiances are still primarily national, and because many other policy instruments are still set at a national level.

The immediate road ahead is less clear. Business and consumer surveys have begun to recover, and in some national markets share prices have risen very sharply, but it is still uncertain how strong any recovery in economic activity in the euro area is likely to be in the next 12–18 months. Global economic activity appears to be recovering somewhat which will help but, on the other hand, the rise in the euro exchange rate is likely to act as something of a dragging anchor on growth (though whether the staff's repeated use of the somewhat pejorative term "stagnation" is warranted in the context of European growth is at least questionable). It is fortunate that the ECB still has considerable room to cut interest rates, without the zero bound coming into view, if inflation continues to ease and appears likely to settle materially below the redefined inflation target. As the staff note, the magnitude of the excess capacity in the economy suggests that further falls in inflation should not be unexpected, reinforced by some, perhaps relatively small, direct price effects of the rising exchange rate. Nonetheless, for the moment we are not seeing clear signs of a further marked fall in inflation.

We wish, however, to focus our comments today on longer-term issues, particularly around the approach taken to Fund surveillance of the euro area. These issues can only become more important in the years ahead as the euro area enlarges, and takes in a number of economies only newly graduating from the transition to a market economy.

A separate Article IV consultation occurs with each of the individual members of EMU. Given that background, and the fact that many policies relevant to longer-term growth and welfare prospects are conducted at a national level, we would encourage the staff to focus surveillance and research efforts for this paper on issues that go to the heart of the monetary union itself, and which capture the intrinsic features of this unique arrangement among diverse sovereign nations. Of course, foremost among those is regional monetary policy (which is covered well here, although more coverage of potential changes in the voting membership of ECB Governing Council might have been helpful). But the other important issues include those relating to an appropriate fiscal framework that takes adequate account of the perceived free-rider risks in a union of this sort, those related to changes in resource mobility across national boundaries, external vulnerability (considered nationally and for the group as a whole), and national differences in economic performance.

It is important to recognize that the European common currency is still something of an experiment—indeed, as the group of member countries grows, perhaps becoming more of one. The broad direction of exchange rate policy, and of the Fund's advice on the issue, over the past 30 years or so has been towards floating exchange rates. There have been good reasons for that shift. If we look around the world, or back through history, we simply do not have many examples of groups of developed countries sustaining for the long term a currency union (or similar arrangement) when: (a) there is no single dominant country; (b) there is a democratic political system with universal suffrage; and (c) well-developed capital markets exist and private capital flows are unconstrained. Ongoing analysis and stress-testing of any system that sets out to make history (and especially one involving such a large share of the world economy) should be an integral and ongoing part of any surveillance undertaken by the Fund, given our responsibilities in the area of exchange rate regimes and international financial systems. In this sort of business a four-year history is interesting, but no more than suggestive. Building a multi-national currency regime seems to be more akin to specifying building standards to help make a city resilient to the once in two hundred years earthquake, with the significant additional complication that political choices do not affect the probability of an earthquake actually happening.

The tensions around the current provisions of the Stability and Growth Pact, and some of the challenges of running a multi-national common currency, were captured well when the Prime Minister of one member country was quoted (in last Saturday's Financial Times) saying "my first duty is to employment and not to solving accounting equations and mathematical problems until some office or other in some country or other is satisfied", while announcing tax cuts that would appear to be directly inconsistent with adherence to the Stability and Growth Pact. When the current provisions of

the Pact appear to be under so much pressure, faced with a relatively mild recession, it is disappointing (to say the least) that the paper before us devotes only a couple of pages to a serious examination of the longer-term issues regarding an appropriate and workable/sustainable fiscal rule for the euro area (welcome as the somewhat-related selected issues paper on pension finance was). There are no easy answers and, as is well known, there is a constant tension between a number of factors, including leaving room for the automatic stabilizers to work, leaving room for national government policy discretion, while avoiding the very serious sorts of national fiscal imbalances that could (at the extreme) jeopardize the union, or impose unreasonable additional costs (higher interest rates or bailout costs) on other member countries. And all the while, in some first-best sense, one size does not fit all, and a prudent debt ceiling may be higher at the height of the retirement bulge than it is now. And yet there is both limited scope for rules to recognize fully those differences, and a need for national policy makers to know the rules of the game they will be facing as the coming difficult decades unfold. We need more, and more extensive, ongoing staff work in this field, and need to be able to discuss and interpret the insights of that work in our discussions at the Board.

One of the local think tanks is currently sponsoring a conference on the future of the euro, one session of which is titled "Will the European Monetary Union Survive?" While not in any way suggesting that the staff pose the question in that manner, the monitoring of the appropriateness of exchange rate regimes, fixed and floating, is a significant part of what the Fund's surveillance should be about. It is not often the case that a particular regime is unambiguously "right" or "wrong", but perhaps more a matter of assessing the alignment of other policies, trying to test the willingness of political systems to make the sorts of decisions required if a particular regime is to prove durable, and assessing the way in which markets are responding to particular choices on emerging issues. For example, given the widespread concerns regarding the possibility of asymmetric shocks, it would be useful to see work on whether the degree of labor market mobility is increasing over time, and between which pairs of countries (and, if not, what policy measures the staff might recommend to increase the effective integration). It would also be useful to see this paper take the opportunity to inform the Board of whether national differences in economic performance are diminishing through time or, if not, where are the imbalances or widening differences (potential points of vulnerability might be appearing).

Recent discussions on surveillance have also highlighted the need for the staff to bring to bear a perspective informed by an awareness of political limitations and constraints—that is surely required nowhere more than in a structure like the EMU where, at times, national politicians will be asked to sacrifice the short-term interests of their own electorate for the good of the union as a whole. Over time, we will need to have good emerging assessments of whether or not, for example, moves in the direction of greater political

union and/or greater centralization of fiscal spending appear likely to be needed to ensure that the monetary union remains robust. And if greater political union is important, surveillance needs to offer us regular analysis and updates of whether that the sort of union is looking more likely. It is, perhaps, a different set of skills than has customarily been required—but this is a currency union representing one of the two main currencies in the world today, which could take in 15 percent of the Fund's total membership within the next few years. Were anything to go wrong, and this institution exists precisely because things can and do go wrong, the ramifications would be globally significant.

We wish the European authorities every success as they grapple with the challenges and opportunities of the enlarging monetary union. Good quality surveillance work from the Fund should help inform their own dialogues and it, and the unfolding experiences of Europe, will have invaluable lessons and insights for other countries, including those such as my own where currency union is often talked of as an economic option for the future.

Mr. Wang and Ms. Cao submitted the following statement:

At the outset, we thank the staff for their candid and wide-ranging discussions with the euro area authorities and for the excellent set of papers. At the same time, we thank Mr. Padoan for his insightful statement.

Lacking the momentum for recovery, the euro area continued to slow down in 2002, but following sluggish activities in the first two quarters of 2003, some signs of recovery have emerged. With accommodative monetary conditions, limited room for a tolerable fiscal stance and the appreciated euro, we still cannot dismiss the risk that the short-term recovery is being weighed down by sluggish domestic investment and dampened external demand. Moreover, labor market rigidity and the high social benefit burden have hampered quick economic adjustment and pose a major constraint to increased potential growth over the medium and long run. Having said this, the key for the authorities in steering the economy back on a healthy track and restarting one of the important engines for world growth is to win wide support from society and press ahead with structural reforms.

As we broadly agree with the staff appraisal, we would like to comment on the following aspects for emphasis.

Monetary Policy and Exchange Rate

The ECB's timely interest rate cut to boost domestic demand and an "accommodative bent" is warranted to sustain the upturn. Due to weak leading indicators, ebbing inflation and the appreciating euro, beginning last

December, the ECB cut interest rates three times and reduced the main refinancing rate from 3.25 percent in November 2001 to 2 percent. Over the past three months, the ECB's decision to hold the current rate up is understandable based on the slightly raised 2004 inflation target and some evidence of an economic rebound. Nevertheless, on account of the slow adjustment in cooperate balance sheets, slow credit growth, the decreasing capital buffer of banks and the relatively high real interest rates in some member countries, a sustained easing bias is warranted until a persistent upturn momentum firms. In addition, we join the staff in welcoming the ECB's declaration that its inflation objective is "below but close to 2 percent".

On the exchange rate, the euro has returned to its medium-term equilibrium level but needs solid support from the fundamentals to remain so. Over the past 18 months, the euro has appreciated by over 30 percent against the dollar in nominal terms and by 20 percent in effective terms with different current account positions and interest rate differentials contributing to this short-term currency movement. While having a negative impact on export expansion, the appreciation of the euro has helped to ease inflation pressure and increase households' real disposable income. Nevertheless, to remain around the medium-term equilibrium rate needs solid support from the fundamentals, including potential growth and productivity growth. After completion of the balance sheet adjustment, we wonder whether banks and non-bank corporates will expand their investment abroad to chase higher profits, thus triggering capital outflow and downward pressure on the euro. Staff comments are welcome.

Fiscal Policy

Owing to lower-than-expected growth rates, most of the euro area member countries may miss their original budgetary targets this year while the major countries are heading toward breaching the 3 percent limit in the Stability and Growth Pact (SGP). While a full play of the automatic fiscal stabilizer is needed when domestic demand is slack, fiscal consolidation should not be postponed any longer with the medium to long-term fiscal pressure arising from population ageing. In this context, to monitor fiscal performance, we support focusing on cyclically adjusted balances rather than that on short-term nominal balances and believe that the credibility of the SGP will be bolstered by healthy economic growth and longer-run fiscal sustainability. At the same time, structural balance consolidation is imperative, even at the current juncture, and should be accelerated when growth picks up. A built-in mechanism would seem to be necessary requiring the authorities to firmly implement structural fiscal consolidation during the bloom period. In this connection, we welcome the structural tightening taken by some member countries. The Broad Economic Policy Guidelines endorsed by the Council this June are a concrete step forward in urging member states which have not achieved close to balance positions to improve their

cyclically-adjusted positions while requiring member states to take all the necessary measures to ensure an annual improvement in the cyclically-adjusted budget position of at least 0.5 percent of GDP. In addition, according to the Commission's research findings, expenditure-based consolidations would be more growth-friendly than those based on tax increases. Here, we would like to hear the staff's view on how to press ahead with tax structure harmonization—including tax cuts—together with the required structural consolidation in the euro area?

Structural Reforms

As mentioned earlier, structural reforms—labor market and pension reforms in particular—are the key to boosting the euro area's growth potential and easing the fiscal pressure imposed by population aging. As the staff clearly states, the lower rates of human resource utilization, to large extent, contribute to the relatively low level of per capita income in the euro area compared with that in the United States. The generous social benefits and potential high pension claims in medium-term have tied the authorities' hands in mobilizing fiscal policies. Having said that, we join the staff in encouraging the authorities to communicate these current and future difficulties to the public and pave the way for concrete reform measures. In addition, we would like to hear the staff's analysis on other major structural problems which may vary across member countries and impede flexible structural adjustment in the economy, including the slow adjustment in corporate balance sheets.

As Mr. Padoan states in his statement, further progress has been made in creating a single market for financial services. We welcome the extension of the Financial Services Action Plan from the securities markets to the banking and insurance sectors and look forward to the full implementation of this Plan by the 2005 deadline. We also welcome the progress made on the financial supervision front and believe the Memorandum of Understanding between the banking supervisory authorities and central banks to be an important legal document clarifying their relationship to better respond to financial crises.

On trade policy, the staff has commented well and fairly on the current EU policies. The chapter on "EU Easter Enlargement: Impact on Trade and FDI" in the Selected Issues Paper is interesting. We also thank Mr. Padoan for updating us on the EU's recent moves on trade policies, including working out a joint framework paper with the United States on agricultural negotiations. The authorities are urged to reform the Common Agricultural Policy further to reduce trade distortions. Their strong commitment to opening EU markets to all developing countries is crucial to the successful conclusion of the Doha Development Agenda.

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

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

Economic weakness continues to linger in the euro area, representing the deep and prolonged nature of the aftermath of the bursting of the equity bubble and existing structural rigidities, and compounded by the appreciation of the euro. While we are encouraged by recent indicators implying recovery prospects, both domestic and abroad, we share the staff's view that the balance of the risks to that forecast is still on the downside. Since we concur with the thrust of the staff's analysis, we will confine our remarks to a few areas of importance.

We commend the ECB for its skillful conduct of monetary policy with increased credibility and clear communication strategy, which has accommodated itself successfully to inflation and output developments. Given the somewhat puzzling stickiness of inflation, uncertain prospects for future recovery, and downward pressure on prices stemming from the unfolding of structural reform efforts, corporate balance sheet adjustments, and the estimated fiscal consolidation process of major countries, the ECB must be vigilant and maintain a well-balanced view with respect to various forces at work on price developments in the area. In particular, developments in corporate balance sheet adjustments should be closely and cautiously monitored since they are often deep-rooted and complex, and thus tend to pose a substantial and prolonged dragging down of the overall economy more than was initially envisaged. Also, from the viewpoint of restoring private investment, which has been identified as a key weakness during the recent slowdown, the transmission mechanism of monetary policy might be another area that warrants examination given corporate reliance on bank financing.

At the same time, as stated in Mr. Padoan's statement, ample liquidity in the area warrants attention as a potential source of inflationary pressures. While such a situation might seem remote, the ECB needs to monitor developments, taking into consideration their potential strategies once the situation warrants exiting from the current accommodative stance.

Continued deterioration in public finances renews focus on the fiscal consolidation path for major countries that breached the Stability and Growth Pact (SPA)'s 3 percent fiscal deficit limit. We note the difference between the authorities respecting the area's current fiscal framework and placing priority on achieving fiscal consolidation, and that of the staff favoring to place more emphasis on the durable achievement of long-term goals. In this regard, procyclical effects and effects stemming from improvement in confidence that the consolidation process entails should be carefully examined. The more the

SGP becomes embedded in the economy, the more binding it becomes in a weak economy, and the more its observance will affect market confidence.

The need for structural reforms in the area has been shared among authorities, but the degree of progress varies from country to country, and the positive effects of reform efforts have yet to bear fruit. Labor markets continue to be a key area. We acknowledge that past events of reduced structural unemployment served as a cushion to absorb small fluctuations and stabilize economic activity, but would like to emphasize that they carry the risk of delaying dynamic adjustment and thereby increasing the cost of adjustment once fluctuations become too large. In a currency union situation, reform in labor markets increasingly becomes urgent as an adjustment mechanism, and we encourage the authorities to promptly tackle the remaining issues already identified and on the agenda.

Finally, we would like to mention the timing of the discussion of this paper. We appreciate having the opportunity to discuss this valuable paper before the Annual Meetings, but the discussion would have been more beneficial if its results could have been incorporated into the World Economic Outlook and the Global Financial Stability Report.

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

We welcome this opportunity to discuss economic policies in the Euro area. This is a timely discussion, especially given the still uncertain prospects for the world economy and the key role the euro area can play in improving the short- and medium-term global outlook.

Economic performance in the euro area continues to be mixed, with signs of the timid economic recovery which began in early 2002 clouded by remaining uncertainties with regard to the speed of adjustments in corporate balance sheets, the impact of the euro's appreciation, and the pace of structural reforms. An important challenge for the authorities lies on the fiscal front, and consists of finding the right balance between responding to the immediate cyclical needs of the area on the one hand, and ensuring that the medium-term fiscal consolidation path is respected, on the other. In view of the subdued short-term growth outlook, due to an important extent to persistent weaknesses in domestic demand, we believe that this balance should be tilted toward supporting the economic recovery and avoiding any contractionary impulse. Similarly, the accommodative stance of monetary policy, which we consider hitherto appropriate, may need to be further eased, especially if the euro does not significantly depreciate and labor market conditions remain soft. Such a fiscal-monetary policy mix would help smooth the adjustment process in the corporate sector by ensuring that monetary conditions are favorable, and minimize the likelihood of larger than necessary rise in unemployment which can further burden public finances.

On the staff's assessment of growth prospects, it would have been useful to expand the growth analysis so as to take into account the impact on the labor market of the planned enlargement of the euro area. Labor migration from prospective member countries in Eastern Europe, in particular from the larger ones (such as Poland) which enjoy significantly higher population and labor force growth and participation rates, will likely alleviate the constraints on labor supply growth underscored in the paper. Of course, this would depend on the extent to which the current liberal policy with regard to intra-euro labor mobility extend to new members. While the growth impact is likely to eventually taper off following the "convergence" effect, it would be helpful to perform some sensitivity analysis, taking this labor mobility factor into consideration, when assessing the growth prospects of the current members of the area. Staff comments on this issue would be welcome.

It is important to point out that, while the staff's outlook for the longer-term growth performance of the euro area looks rather bleak, it could be improved, even if modestly, through shifts in the policy stance or an acceleration in structural reforms. Improvements in the rates of labor utilization would certainly have an impact on raising potential output levels, and, if the improvements in utilization rates are substantial enough, these could translate in higher potential output growth over several years, during which the adverse growth impact of a stagnant or declining working-age population would be at least partly offset. This analysis would certainly allow a more complete assessment of the pros and cons of changing certain economic incentives so as to raise labor utilization rates (for example through the narrowing of the wedge between labor and consumption taxes). In the same vein, we note that the growth projections assume a constant capital-labor ratio. While many of the constraints on the growth of the labor input, such as the low fertility rates and rising life expectancy, are appropriately taken as given, the rate of growth of capital is, on the other hand, strongly influenced by policy choices. In this context it would be useful to probe the extent to which the growth impact of a stagnant working age population could be offset through higher investment rates, which are likely to be induced by many of the structural reforms advocated in the paper and an improvement in the composition of government expenditures from recurrent items (such as transfers) toward more growth-enhancing public investment. Staff comments would be welcome.

On fiscal policy, a history of unfulfilled consolidation plans, untimely tax cuts and one-off operations has certainly not enhanced the credibility of fiscal policy frameworks in the Euro area. Given the current environment of weak demand conditions and uncertain prospects, we do not believe it would be credible to insist on containing fiscal deficits in member countries to the SGP requirement of 3 percent. A number of countries have exceeded the prescribed limit in 2002 and the potential for more breaches this year is high.

We believe that the current environment calls for exercising flexibility in judging adherence to the 3 percent limit until the economic turnaround is firmly in place.

The delicacy of the current situation has brought forward an important and healthy discussion of the need to set short-term goals and limits. We do share the staff's view that a fiscal framework for the region is essential. Such a framework needs to account for the underlying sustainability of public finances in each country to effectively prevent negative externalities and avoid the need to cross subsidize. We agree with the staff's suggestion that fiscal policies should become more forward-looking, with an increasing focus on growth through judicious structural reforms rather than excessive short-term demand management. It is particularly important to avoid compromising long term fiscal goals for the sake of reaching short-term improvements in the fiscal position. In that context, the "standard" advocated by the staff of aiming at steady fiscal adjustment (mainly through structural reforms), but with room for cumulative adjustment in case of delays, is appropriately flexible.

On trade policies, we share the staff's views that the contemplated reform of the Common Agricultural Policy falls far short of the Doha round objectives. We encourage the EU authorities to take bolder actions to improve the access of low-income and developing countries to their market, and adopt a much more ambitious pace for the reduction of tariffs, in particular for agricultural products. This would be beneficial both for Europe itself and the developing world.

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

This year the staff's main report on the developments in the euro area is a sober and realistic account of the regional developments. The integration into the EMU in the 1990's brought important benefits to member countries and a lot was achieved in coordinating their economies. In recent years, it became apparent that the initial reforms have exhausted their momentum, and the euro area economies, as a whole, entered from the second half of 2002 a period of "virtual stagnation", as eloquently defined by the staff. The reasons for such stagnation, especially on the structural front, are well-defined in the staff report, and, with most of them being recurring, we do not see a need to dwell on them in detail. Rather, we would comment on more fluid developments.

We find it worrisome that the staff see the stagnation being overcome only gradually and that some major unaddressed reform issues will continue to stand in a way of achieving a more rapid growth in the euro area. For an expedient improvement of the economic situation it is apparent that progress is necessary not only in the implementation of policies and reforms but also in their coordination and cohesion. In this regard, it is not helpful that the

continuing rift between the European Commission and EMU's largest members on the appropriate fiscal policy and the subscription to the rules under the SGP has demonstrated a lack of such coordination.

The main problem in the euro zone relates to the achievement of a trade-off between the long-term policy requirements and the shorter-term growth considerations. It is apparent that this issue is not particularly clear-cut. On the one hand, we share the concerns of the EC and ECB regarding the risks of running a loose fiscal policy at the time of already high spending and deficits. This could cancel out positive Keynesian effects and suppress consumer confidence and spending rather than stimulate them. On the other hand, we recognize the hesitation of some governments to cut significantly their expenditure levels and move to more balanced budgets at the time of recessions or nascent recoveries of their economies. This last point, however, deserves further consideration. In some country cases, boosting growth in 2004 is envisaged through tax cuts. While tax rates in these countries are high and severely distort incentives, mostly in the labor market, we are not quite sure that their reduction, as a short-term goal rather than a longer-term structural reform objective, will guarantee the pick up in growth, generate more tax receipts that would ultimately reverse the budget deficit, as the authorities hope. Furthermore, the continuing social pressures for the increase in spending as well as opposition to spending reductions in some countries could further exacerbate the fragility of the fiscal situation.

In the context of a monetary union there is little doubt that a fiscal framework, which allows the ECB to maintain price stability, is required. In this regard, we welcome the staff's participation in the debate on whether the SGP is the right framework. We share the staff's views on the appropriateness of 3 percent deficit limit and on the need to place limits on the annual nominal flow deficits. We also share the staff view that currently a fiscal adjustment in the structural balance of, at a minimum, 0.5 percent is necessary, even if this keeps the deficit above the 3 percent target. It was interesting to learn from the report that the European Commission's recent cross-country work showed that fiscal consolidations in Europe led to the acceleration of growth in about half of the historical episodes. While this evidence is not convincingly conclusive one way or the other, we agree with the staff that past fiscal lapses, which resulted in growth of cyclically-adjusted deficits, have limited the available fiscal options to improve growth.

As to the monetary developments, it is worth noting that, indeed, inflation has been persistent and sticky during the few past years, which made it much more difficult for the ECB to aid growth through interest rate reductions while maintaining inflation in the defined range. Going forward, its task will not become easier, as inflation projections are subject to important uncertainties and risks. As the staff, we welcome the clarification by the ECB of the inflation objective and the role played by monetary analysis, a

recommendation that has been voiced by the Fund in previous years. This decision will provide additional transparency and benefits to the market and improve the efficiency of the ECB's actions.

It is disappointing that, contrary to expectations, the initiation of the EMU did not provide enough impetus to the pace of labor market reform. While we welcome the fact that there is agreement in principle between the countries that labor reforms are urgent, there has not been a significant progress in this area so far. Therefore, we very much hope that next year's discussion on euro area policies will show much greater progress on the most welcome initiatives in the labor market and pension reforms described in paragraph 43. In this vein, we would single out progress in the financial sector area and hope that this can serve as an example of good cooperation and coordination between members of the euro zone in the structural area.

Lastly, we cannot overemphasize the fact that the pace of progress in the trade policy area needs to be invigorated. The recent amendments to the CAP, although a step forward, do not address the most pressing issues, such as access to the EU market of developing countries' agricultural products and significant peak tariff cuts. Further, with the enlargement of the EU, as the staff, we see problems arising from a potentially more difficult access of neighboring non-member countries, including some smaller CIS countries, to the markets in the larger EU as a result of trade protection measures that the new members will have to take upon themselves when joining the Union. We encourage the EU to work with the potentially affected countries on initiatives to mitigate the short-term impact of the enlargement on the regional and cross-border trade.

Mr. Kremers submitted the following statement:

Key risks for euro area recovery have become more balanced. Corporate balance sheets are improving, although the process is far from complete. Financial markets have become more optimistic and the improved outlook for the United States may benefit the euro area recovery.

I welcome the staff's analysis of fiscal and structural issues in the euro area, and broadly agree with the staff's recommendations. In particular, I fully agree that fiscal policies should be forward-looking, and that a sound fiscal framework continues to be essential in the EMU. The SGP is such a framework. However, I do not endorse the staff's suggestion to allow the required consolidation effort of 0.5 percent of GDP a year in cyclically adjusted terms to be met on a multi-annual cumulative basis.

The pace of labor market reform is too slow in some euro area countries, where the target participation rate of 70 percent in 2010 seems quite difficult to achieve.

I welcome the well-focused report and the thrust of the analysis, and I support most of the recommendations. I also share Mr. Padoan's statement in full and would like to add a few specific points.

Economic Outlook—Cyclical and Structural Factors

All in all, risks to euro area recovery seem balanced. As the staff rightly states, a risk to euro area recovery constitutes the continuation of corporate balance sheet adjustment. Although physical overcapacity may be limited (contrary to the United States where utilization rates are still at historically low levels), financial over-leverage continues to hamper investment, as also noted by Mr. Portugal and Mr. Steiner. The recent rise of long term bond yields, which is most pronounced for the United States, could prove to have come too early for the euro area where growth remains weak. On the other hand, the improved outlook for the United States may benefit euro area recovery, while monetary and financial conditions are favorable. Nonetheless, Europe's economic position necessitates being more active in conducting structural reforms directed at product and labor markets.

Despite the fact that some European countries—notably France and Germany—will breach the 3 percent-deficit limit of the Stability and Growth Pact (SGP) this year, this fiscal framework should enhance confidence in the sustainability of government finances, therefore putting less upward pressure on interest rates compared to the United States. Sound government finances, combined with the active implementation of structural reforms are essential to a sustained recovery in the euro area.

Fiscal Policy

I share the staff's view that fiscal policies should be forward-looking, to cope with the rapidly approaching challenges of the ageing population. In particular, I fully agree with the staff that the underlying budgetary position needs to be balanced in order to guarantee fiscal sustainability. The current fiscal developments very clearly underline the need for a sound, justifiable, credible and enforceable fiscal framework. The Stability and Growth Pact is such a framework, designed to promote fiscal sustainability in good times and be sufficiently accommodating in bad times.

As the staff rightly notes, it has been past lapses in fiscal discipline and not the fiscal framework itself, that have limited current fiscal leeway in some euro area countries. The fiscal framework as laid out in the SGP should therefore be respected. Fiscal stimulus per se is not an effective tool to jumpstart the economy. When fiscal stimulus goes together with a severe deterioration of government finances, a weakening of confidence can lead to higher private savings, undermining the desired stimulating effect. In this context, any cyclical contribution of budgetary policy should be limited to

allowing automatic stabilizers to work, provided that public finances are and remain on a sound footing.

Consolidation in most European countries with large shares of public spending and taxation is best achieved by expenditure cuts. Tax increases should be avoided. It should be noted however, that in some areas, increases in taxes and premiums should not be eschewed when they lessen distortions of incentives. In the health care sector, for example, increasing premiums (and the share of co-payments) may be advisable in some euro area countries.

I agree with the Commission that budgetary monitoring should focus on underlying (cyclically adjusted) figures, but that a nominal anchor is necessary as well. We should be well aware that the estimates of cyclically adjusted figures are surrounded by uncertainties. These uncertainties are only partly related to the specific method used. Perhaps more important is the fact that the monitoring process necessarily involves extrapolation and projection, which entails uncertainties that tend to reinforce each other. While monitoring the improvement of the underlying balance is of importance, consolidation efforts should therefore always be evaluated more broadly.

Countries with weak underlying positions should realize a yearly improvement of their underlying balance by at least 0.5 percent of GDP, in conformity with the SGP. Given that achieving consolidation rather than postponing it is the appropriate way to ensure sound and sustainable public finances, any delays in this pace of consolidation should be avoided. Therefore, I do not endorse the staff's suggestion to instead allow for a cumulative improvement of the cyclically-adjusted balance of 1.5 percent during 2004–06. This could induce backloading of necessary consolidation efforts.

Structural Reforms

The staff rightly notes that the overall record of implementation of the targets set by the European Council in Lisbon has been disappointing. In the period 1995–2001 labor participation rates in the EU rose on average 0.7 percent per year, mainly the result of women entering the labor market. Front runners include countries such as Ireland, Spain, the Netherlands, Finland and Portugal. Although the success of these frontrunners may be explained by different factors, it is striking that they put more effort on reforming their labor markets than the laggards, for instance in the domain of active labor market policies or the implementation of more flexible work contracts. Indeed, it could be argued that in some aspects the EU labor market is by now more flexible than that of the United States. While average hours per worker are significantly lower than in the United States (thus, in my view, explaining almost completely the difference in GDP per capita), this is not only the result of lifestyle choices and rigidities in Europe, but also of rigidities in the United

States, where higher paid part-time jobs are practically unheard of. While the United States bias towards longer hours results in a higher GDP per capita, this is does not necessarily have to be a utility-maximizing optimum.

That said, I of course fully agree with the staff that the overall pace of labor market reform in Europe should be increased. Despite the fact that labor participation rates in the EU have been rising, there is hardly any reason to be complacent. First, given the current speed, a number of countries will not reach the target of a participation rate of 70 percent by 2010. This holds for France, Italy, Greece, and Belgium. Second efforts to raise participation rates are seriously hampered by the current economic downturn. With rising unemployment, inactive people are discouraged to enter the labor market. Finally, the share of older workers in the labor force will increase substantially in the coming decade due to ageing. The participation rate of older workers in the EU is below 40 percent, compared to 60 percent for the United States. I therefore agree with the staff that reforming pension systems, including measures that increase the incentives for postponing retirement, need priority.

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

Key Points

Growth prospects for the euro area continue to be downgraded. Performance in the first half of 2003 is quite disappointing, particularly in the largest economies.

The ECB needs to be cautious about risks on the downside given current trends in inflation and appreciation of the euro this year.

Under the Stability and Growth Pact, the limits on fiscal deficits place a greater burden on monetary policy and structural reforms. Progress on the latter has slowed, according to the European Commission, rather than accelerated.

Since the last euro area review, the economic situation has deteriorated beyond the pessimistic forecasts discussed at that time. The staff update of September 8 confirms that growth has been more sluggish than forecasted, inflation has remained “sticky”, unemployment is beginning to rise, and the overall fiscal situation has deteriorated in the short term, with consequent effects on the ability to adjust to longer-term trends. At the same time, the fiscal policy lever is reaching its limits in the largest euro area economies under the rules of the Stability and Growth Pact (SGP). Given these developments, the euro area has been unable to provide significant support to the global recovery or to address the enduring ‘global imbalances’. As the Managing Director stated in his reply to Mr. Vittas’s query earlier this year,

"First, and most importantly, there is an urgent need to address the structural weakness in European growth performance. This will require tackling the root causes of anemic growth through a vigorous acceleration of structural reforms."

We are pleased to see that the euro area authorities have turned their focus from external vulnerabilities, which seemed to dominate their perspective during last year's review, to domestic vulnerabilities and weaknesses that are impeding growth. We welcome the commitment to the structural agenda highlighted in Mr. Padoan's statement.

Structural Policy

Boosting productivity growth is as essential for Europe as for the United States and the rest of the world. The staff report notes that productivity growth in the euro area was slightly above growth in the United States during 1990–2000. This timeframe obscures the apparent secular increase in productivity growth in the United States that began in the mid-1990s. Is there much evidence that such an increase in productivity is occurring in the euro area?

The staff rightly notes that the bulk of the sizable differences between the level of per capita GDP in the euro area and the United States is due to a lower rate of utilization of human resources, which largely reflects tax policies and other economic disincentives to work. Policies to encourage workforce participation are needed to address this problem, particularly in view of the stagnation in population growth.

Euro area member states have begun to move forward on some aspects of structural reforms, but by the EC's own standards much work remains to be done in order to meet the goals set out in the Lisbon agenda. According to the Commission's assessment of the Broad Economic Policy Guidelines, labor market reform, in particular, continues to be done in a slow, piecemeal fashion. And, the chart on page 25 of the staff report indicates that little progress has been made overall since the late 1970s. Some countries, including Germany, have initiated new efforts to address labor market issues, and we look forward to the Article IV consultations to discuss the details.

The staff also points out the slowdown in product market integration. Incomplete progress here will be further complicated next year as the EU attempts to integrate 10 new members into the common market.

Monetary Policy

There appears to be some difference of views between the staff assessment of inflation and monetary policy and that of the authorities. While

the latter are emphasizing low interest rates, the medium-term aspects of monetary policy, and the growth in liquidity reflected in M3, the staff points to the downside risks to inflation and notes the higher cost of undershooting than overshooting the inflation objective.

We agree that the risk to inflation appears to be on the downside. Excluding food and energy, consumer inflation this year has been running at an annualized rate of around 0.8 percent. Increases in producer prices in intermediate and capital goods have been even lower. Further growth weakness in the second quarter and the strength of the euro suggest there is still scope for a more accommodative monetary policy if economic weakness continues. The ECB has maintained a two-pillar monetary strategy that looks at both short-term factors and long-term monetary analysis, but the latest monetary strategy review implied that the ECB would focus more on the first of these, where there is a risk that inflation will come in well below the target of close to, but less than, 2 percent.

We appreciate that the staff has explored the issue of inflation persistence in the selected issues papers. Based on this work, the inflation response lag compared to the United States, although small, seems to be attributable to slower responses to output developments and the more flexible product and labor markets in the United States.

We look forward to the staff paper cited in footnote 8 that will provide a more in-depth analysis on the macroeconomic dimensions of the integration of new members into the monetary policy environment. While euro area officials have tried to clarify the requirements for entrance into the EMU, particularly the application of the ERM II mechanism, the result has too often been further confusion. There needs to be continued discussion about the applicability of these conditions to the new member states that are far from economic convergence. In particular, the use of an inflation target based on the three lowest-inflation countries could be inappropriate if those countries are on the verge of or experiencing deflation. The inflation gap would only be increased by the Balassa-Samuelson effect, which predicts that inflation will be consistently higher than in the more highly developed EU economies.

Fiscal Policy

The developments in fiscal policy have not been positive in the largest economies of the euro area, and the tensions over the direction and magnitude of fiscal adjustments in light of the sluggish or contracting economies appears to be one of the more politically sensitive areas in the euro area.

The staff has touched upon the key dilemma in enforcing the strictures of the Stability and Growth Pact (SGP), particularly the limit on the fiscal deficit of 3.0 percent of GDP. The original intent of the 3 percent deficit rule

was to allow sufficient space for the fiscal response of stabilizers during a slowdown—provided that the fiscal situation was already close to balance. In that light, we understand the Commission's insistence on maintaining the 3 percent limit. Tolerating significant deviations from the limit can undermine the credibility of the SGP, particularly among member states that have taken measures in the past to abide by this rule. And, we note the important evidence that the impact of contractionary fiscal policy on growth is mixed, with expenditure-based consolidations being more supportive of growth than consolidations based on tax hikes.

At the same time, we understand the concerns raised by the staff that measures taken to restore compliance with the 3 percent rule not exacerbate an economic downturn. In this respect, the staff's proposal that the SGP be applied in such a way that a country can exceed the deficit limit in a slowdown, provided that it takes steps on the structural side to bring the deficit back towards the limit, echoes in principle the proposals approved by the Economic and Financial Council to take account of the business cycle and the sustainability of public finances. The implementation of any such plan will be difficult given the complications of determining the structural and cyclical components of budget. And, we note that the staff is arguing that any shortfall in meeting the planned structural adjustment of 0.5 percent of GDP in 2004 should be made up in 2005 or 2006.

Regardless of the outcome of the debate on short-term fiscal developments, the staff rightly points out the need to look at fiscal developments with a view towards the medium- and long-term burdens on public finances. It is particularly useful that the staff has examined the long-term implications of current demographic trends upon pension systems. The analysis is based on numbers put out by the Commission that show a discouraging prospect of aging populations and lower potential GDP growth. The latter reflects the factors outlined in the staff report: lower labor participation, lower productivity, and fewer hours worked (per year and over the lifetime of a worker).

While the results of this long-term analysis are not breaking news, and there appears to be a general acceptance among European citizens that the system needs to be fixed, there is little public support for real change. The recent waves of protest strikes over proposed reforms reinforces the assessment that euro area governments will need to engage in significant public awareness campaigns to pass meaningful reforms.

Trade Policy

The EU has an essential role to play in the ongoing Doha trade negotiations, particularly in view of its 'pivotal' position in agriculture. We

agree that EU leadership will be key to achieving ambitious results in the Doha Round.

The staff report suggests that the Commission has some (but not 'lasting') resistance to multilateral trade liberalization in order to mitigate the potentially detrimental impact on poor countries with preferential access. This argument is not compelling. Multilateral liberalization would have significant benefits for most countries by generating new exports. Foregoing reductions in tariff and non-tariff barriers for large numbers of low-income and emerging market economies is a damaging and counterproductive way to promote development objectives for other poor countries.

Mr. Alazzaz submitted the following statement:

The euro area economic outcome has again fallen short of earlier expectations. The Board discussion last year looked back on a "disappointing" year and foresaw "continued tepid growth in the near term" followed by a pick up in 2003. In the event, growth fell by two-thirds to 0.5 percent in 2002 and 2003 with a projected rise to 2 percent in 2004. The positive signs in the staff update are indeed welcome, but the report rightly stresses that the balance of risks on the prospects remains on the downside.

Against that background, the question is how soon the euro area can take up its role as a source for global growth. Given the concerns over continued excessive global dependence on the U.S. market, it is impossible to overstate either the regional or the worldwide significance of an early upturn in the euro area. In the absence of any major exogenous shocks, the performance necessarily reflects cyclical and structural factors, as Mr. Padoan and the staff have rightly noted. The policy focus, therefore, should be on the scope for anti-cyclical stimulation and faster structural reforms. On both counts, the euro area policies continue to confront fundamental as well as discretionary constraints.

The urgency of shifting from the United States to the regional market for the growth impetus has to be dealt with in an economy hamstrung by the fundamental constraints of a declining population and low labor market participation rates. A major focus of policies should be, therefore, on more open and flexible labor markets. Given a restrictive labor market, and the low work participation that the authorities suggest is a "lifestyle choice", it would seem that the euro area could settle down to continued tepid growth or worse. Here, I share the staff's suggestion that these lifestyle choices of low work participation likely reflect the enabling complex of long-standing economic incentives. I encourage the staff to have greater focus on these issues with a view to identifying the instances of practices inhibiting the acceptance and creation of paying jobs.

The fundamental demographic issues also impinge on the room for anti-cyclical policies in the euro area. Indeed, the all-too-real longer-term policy challenges provide the rationale for the self-imposed numerical bounds for monetary policy under the European Central Bank and the fiscal stance under the Stability and Growth Pact. Setting such arbitrary goals is, however, an extremely difficult, if not impossible, task in view of the underlying rapid demographic, technological, and financial changes. At the very least, this demands a determined effort to use all available scope for anti-cyclical policies.

Against that background, I continue to share the widely held view that the euro area outcome has long warranted a more accommodative monetary policy stance. Indeed, the scope for further easing has been stressed repeatedly within and outside the Fund, including during the latest Board discussion of the World Economic Outlook. I therefore find the staff somewhat unduly guarded in its support of an "accommodative bent" in the monetary stance. Indeed, I am not convinced by the staff's argument regarding the region's lower potential growth and stickiness of inflation. This argument requires further scrutiny in view of the well-known tendency of the available empirical estimates to understate the potential for growth and overstate the extent of actual inflation.

Regarding the stickiness of inflation in the euro area, it will be helpful if the staff explains the nature of the problem. Indeed, stickiness at the current low level of inflation should not be a matter for concern. Furthermore, Fund surveillance could legitimately cover the rationale behind the ECB's particular choice of the "below but close to 2 percent" rule. Greater focus on the structure rather than the aggregate of inflation also could allow for a proper perspective on whether all of the price pressures should be treated similarly. Such enquiries could give freer scope for the staff's suggested anti-cyclical monetary policy bent to be effective. Indeed, the long-standing concerns that the ECB's inflation target is excessively ambitious are somewhat vindicated in the frequent reference now to the dangers of deflation.

On fiscal policy, the euro area is straining to abide by the preset budgetary goals under the Stability and Growth Pact. The staff makes several allusions to the argument that the fiscal stance should be more sensitive to the requirements of the current cyclical juncture. Indeed, a reference is also made to suggestions for reflationary policies. At the same time, the staff asserts that that credibility and growth prospects would be better served if the countries adhered to their commitments under the SGP. Here, I see a need to make an unambiguous and strong case for flexibility at this stage of the cycle in the context of a medium-term framework to address the economy's longer-term fiscal objectives.

On structural policy, I welcome the European Commission's findings on the differing experiences within the euro area. Given also the evidence of an increased awareness of the need for reforms, it is opportune now to have a comprehensive approach of tailoring reforms as needed within the region. Here, I am encouraged by the widening recognition that substantial and sustained reforms, especially in the labor market, will be essential to realize the Lisbon agenda for raising employment and productivity levels. In that regard, the revival of labor market and social security reforms in the larger countries is encouraging. In other structural reforms, I commend the progress in the financial markets area within and beyond the original measures of the Financial Services Action Plan.

Finally, it is important to stress that further liberalization of trade policies of the euro area is crucial for success of the Doha Development Agenda. It is therefore important for the region to play a leading role in opening trade to the developing countries. In particular, I urge early action on greater market access to exports from the developing countries and reduction of the high taxation of petroleum products.

Mr. Zurbrügg and Mr. Inderbinen submitted the following statement:

Our assessment of the euro area's short term economic prospects is similar to the staff's projection presented in the revised WEO: we also expect the GDP to grow by about 0.5 percent in 2003. However, for the next year we envisage a somewhat slower recovery and we believe that the euro area may grow by about half a percentage point slower than currently forecast by the staff. The difference stems mainly from our lower projections for private consumption and gross fixed investment. Despite the recent upturn in some leading indicators we still see a rather significant risk that investment demand will remain subdued as the manufacturing index has yet to cross the 50 points threshold and the order books are fairly slim. Private consumption growth is also likely to remain fragile as the high and rising unemployment can be expected to dampen consumer spending.

We find it fully appropriate to assume that the recovery in Europe will be supported by the expected improvement in external demand but we also see this source of growth as an important risk to the outlook. A faltering United States recovery would put a brake on the expansion of the world economy, and would have strong negative effects on the expected growth in the euro area. This risk seems to be more important than that of a continued corporate balance sheet adjustment, or an overshooting of the euro.

The monetary policy of the ECB has responded well to the various challenges faced by the EMU. We thus share the view that the ECB has already established a solid track record. Concerning the outlook and the future stance of monetary policy, we agree with the staff that the ECB should

maintain a sustained an easing bias. Inflation persistence appears to be lower than the experience of the past years might suggest. And, more importantly, the outlook for inflation is rather benign. Like the staff, we expect the euro area-wide inflation to decline next year to about 1.5 percent.

However, we also see some important arguments in favor of prudence in the conduct of monetary policy. Out-of line wage increases cannot be ruled out. Notwithstanding our more pessimistic growth forecast, a somewhat better outcome can not be excluded either. In such a case, economic agents could adopt a pricing behavior that is all but friendly to the inflation outlook. Taking into account the long lags of monetary policy, and the fact that there already is substantial liquidity in the system, we can understand the ECB's reluctance to move too aggressively in the direction of lower interest rates. In this regard, a description in the staff report of the evolution of monetary aggregates, and of M3 in particular, would have been welcome. It appears that the "streamlining" of the statistical tables in the report went a bit too far with the absence of any data that would show developments in main monetary aggregates. Like some other Directors, we would be interested in a more detailed assessment of the significance of, and risks resulting from, the apparent liquidity overhang. The recent uptick in inflation, and the subsequent upward revision in the staff's inflation forecast, as well as the staff's finding that euro area-wide deflation should be seen as a remote risk, can, in our view be seen as yet another argument in favor of a more conservative monetary policy stance. In more general terms, we would like to stress the importance for the ECB of relying on a forward-looking approach to monetary policy, giving due attention to the uncertainties that affect economic and inflation perspectives.

We see the recent revisions to the monetary policy framework as a very welcome step in the right direction. The clarification of the definition of price stability and of the role of monetary analysis are indeed helpful. These clarifications will certainly facilitate the communication strategy of the ECB and thus help understand its monetary policy stance and actions.

On fiscal policy, we find it very regrettable that some countries are expected to breach the 3 percent budget deficit limit in 2004 for the third year in a row. The fiscal exuberance during the previous upswing clearly contributed to the current difficulties with observing this nominal ceiling. These problems, as well as various pressures on revising the SGP rules, also expose some serious flows in the whole fiscal framework that proved not to be effective in pushing countries closer to structural balance in the strong growth period. We believe that trying to remove this weakness could be seen as more important than the current discussion on increasing the flexibility of the nominal ceiling. In principle, the SGP offers ample room for automatic stabilizers to play but of course only when the general rule of a balanced or surplus structural position is strictly observed. The "debt brake" recently adopted by Switzerland has the potential of being a more effective mechanism

for enforcing fiscal discipline during cyclical upswings as it de facto obliges to run surpluses during such "better times."

We agree with the staff the EMU members not fulfilling the SGP requirements should aim at a cumulative reduction in their structural deficits over the next few years. This would be preferable to sharply contracting fiscal policy in the very short run in order to avoid breaching the 3 percent deficit ceiling at all costs. It would strike a balance between the long-run objectives and some short-run exigencies and could also help to improve the very disappointing with regard to the quality of fiscal adjustment. However, such a policy might well be viewed with scepticism in view of recent fiscal slippages. It would thus need to be strictly observed in order to restore the credibility of fiscal authorities. Credibility is critical both for maintaining stability within the euro area and avoiding the creation of a double standard for large and small EMU member countries.

In sum, while we are in principle open to applying countercyclical fiscal policies and recognize that some flexibility may be necessary, we are strongly convinced that a firm and credible commitment to fiscal consolidation is vital. A budget which is balanced over the medium term, as foreseen under the SGP, provides a sound basis for sustainable growth. Also, a credible fiscal framework is critical for the success of a monetary union.

We noted that in paragraph 34, and in the appraisal, the staff recommends curbing spending on transfers and on public sector employment. While in principle we have no objection to this recommendation it would have been preferable if the report had provided some justification for giving priority to cuts in these two areas.

The looming problems of aging and pension financing strongly underline the importance of a more determined structural reform effort. We agree with the staff that increasing the supply of labor—be it by raising the incentives for retiring later, by implementing broader-based reforms that boost potential growth, or by immigration—is an important part of the strategy for the euro area to face the challenge of an aging population. Increasing productivity will also be important, as will reducing public debt levels.

Mr. Duquesne submitted the following statement:

We thank the staff for a very interesting set of papers. We can broadly agree with their policy conclusions. We associate ourselves with Mr. Padoan's well-balanced statement which underlines the encouraging signs for a recovery, and the need to pursue structural reforms to step up growth potential. Therefore, we have only a few additional comments.

Regarding the short-term outlook, we agree with the staff that signs of improving sentiment (soft data) are encouraging, while their translation into hard data has still to materialize. Beyond confidence indicators, and as pointed out by Mr. Padoan, real disposable income is rising and should provide more support for consumption as inflation declines. Moreover, the adjustment of the corporate balance sheets is under way. Regarding the latter, the report suggests—reflecting a similar analysis in the WEO—that a slower pace of adjustment of the balance sheets than in the United States would presumably hamper a rapid pick-up in investment. This is a pivotal issue, and the staff's comments on the "preliminary indications" leading to this assessment would be welcome. In the same vein, one may question Figure 1 of the report showing that the ratio of debt to internal funds has continued to rise from 2000 to 2002, whereas it has stagnated in the United States: the staff may wish to specify their projections methodology used for the euro area.

In any case, the expected gradual rebound of growth in Europe will be favored by sound macroeconomic fundamentals. The euro area benefits from relatively low interest rates which are supportive to growth. We concur with the staff's global appraisal and recommendations on the ECB policy. In the current juncture, monetary policy has a key role to play to preserve the return of confidence through favorable financing conditions, low inflation, but also more room for adjustment than in the other major economies, especially if the euro were to strengthen again. In this regard, we fully share Mr. Padoan's and the staff's view that a more equitable global distribution of any further adjustment burden is desirable. Importantly, Mr. Padoan also mentions that there is no macroeconomic imbalances in the euro area. A possible decline in the relatively high level of private savings could be an important source of growth. Furthermore, growth in Europe will not be impeded by structural external imbalances: the euro area still records large external trade and current account surpluses despite the fall in external demand over the course of 2002–2003.

On a longer-term perspective, a key factor reported by the staff is that GDP growth per capita over the last decade has been similar in the euro area and in the United States, and that productivity growth per capita was even higher. This is important to highlight not only because a commonly held view is that productivity lags behind in Europe, but also because productivity growth is an essential driving force in investors' decisions. Nevertheless, we obviously concur with the staff's analysis which identifies demographics as the main source of problems faced by the euro area. Box 2 of the report illustrates the magnitude of its impact on potential output growth and future incomes (moreover, there is little to expect from EU and euro area enlargement, since the future member countries are generally on an aging trend). Therefore, there is no doubt that further structural reforms are needed. The process takes time. That is why, like Mr. Padoan, we welcome the increased emphasis put by the staff on a long-term perspective regarding the

link between structural reforms and the sustainability of public finances in the long run, which remains the ultimate objective. This approach is all the more necessary regarding aging contingent liabilities. This leads us to broadly concur with the staff's analysis on public finances and fiscal policy.

As an example, and even though we fully share the idea that the euro area as a whole is under discussion and not country-specific cases for which the Article IV consultation reviews provide in-depth examinations, we would recall that in France, the (difficult) implementation of the recent pension reform is the outcome of a decade-long wide public debate which has proved to be useful. According to our authorities' estimates for the period 2004–2040, this reform could save as much as 1 percent of GDP in net present value, supplemented by some additional gains resulting from an increase in potential growth.

Finally, we thank the staff for the five interesting and timely Selected Issues studies. Their conclusions could have been more explicit and highlighted, as they could provide some guidance to policy makers. In this regard, the study on exchange rate pass-through and external adjustment could have further specified the differential impact within the euro area of a dollar decline.

To conclude, after almost five years of existence, the European Monetary Union has proved to be resistant to severe economic shocks and, as noted by Mr. Padoan, to keep structural reform on its policy agenda.

Mr. Usman submitted the following statement:

Key Issues

Indications from the staff assessment of current performance of the EU are that it falls short of expectations and that there are downside risks towards deflation in the near-term if urgent and appropriate reforms are not undertaken, especially in the economies of the three largest members.

The EU, as a result of its impact on the world economy, owes the responsibility of avoiding the deflation potential and making its economic policies impact positively on the rest of the world, by adopting a more forward-looking set of reforms and purging itself of the traditional resistance to reforms, as well as the stop-go approach to policy adjustments.

In particular, challenges remain in the formulation of a pro-active fiscal framework to address the problem of fiscal sustainability; rigidities in the labor force and the slowing of labor growth; population aging and the attendant excessive pension benefits, which impact adversely on fiscal

consolidation; the discretionary labor taxes and the disincentive to labor; corporate adjustment; and the need for adjustment to the monetary policy.

The EU's trade policy should adopt far more adjustments than is currently available under the CAP to include market access and elimination of subsidies, if the union is to be seen to be taken serious about its agreement to be supportive of the economic development and poverty reduction in developing countries.

We thank the staff for very analytical and concise set of reports. For a start, we observe in the report that there is a decline in the exports and investments of the EU countries, which was occasioned by an appreciation of the euro, as well as labor market rigidities and deliberate administrative strategy to keep ailing corporations afloat and suspend corporate adjustments. More worrisome is the assessment by the staff that the challenges may well continue into the medium term, with the potential risk of deflation. Like Mr. Redell alluded to in his preliminary statement, we find striking similarities in the experiences of the EU and the United States in recent years, and indeed, in the factors that might contribute to deflation prospects.

We also note that reforms have been needed for sometime now to address these challenges, and a very clear message which cannot be missed in the report to the euro countries is that there is no running away from adopting reforms in the relevant areas, as delays will not only affect short-run developments, but also the prospects for the medium to long-term. In addition, the reforms must be seen to systematically shift toward more forward-looking and sustained regional approaches and national policies.

Unfortunately, there is palpable evidence, as alluded to by the staff in the reports, that resistance to reform has been a long tradition, it remains strong and has the potential of strengthening as economic situation improves. We also note in the staff report that, for now, a stop-go approach is being adopted by many countries in the region in the implementation of necessary reforms. The general trend indicates that implementation of reforms, especially in the three large economies in the union is somewhat strong during poor times, but lax when economic performance is strong.

In view of these disconcerting indicators, there is no gainsaying the fact that this is not a good state of affairs for an economic area that has an important influence on the world economy. We would therefore urge the authorities of the member countries of the euro area to make concerted efforts to quickly address the challenges of a potential for deflation in the region, which current economic developments dictate. In a similar vein of urging the EU to impact the world economy positively, we support the staff view that the union should revisit its regional strategy for ACP countries, based on the Economic Partnership Agreements, and endeavor to minimize the protection

placed on the domestic substitutes of the exports of developing countries, as well as the restrictions placed on them in accessing the euro regional market.

We welcome the recent positive developments in the financial market, in which equity prices and bond yields have been rallying, and the appreciation of the euro is adjusting to make it more competitive. Monetary policy has also adjusted well, as the EU's inflation objective has been properly clarified, and has provided a clear anchor for longer-run inflationary expectations and against shocks that could lead to area-wide deflation. But like Mr. Le Fort and Mr. Franken, we will advise a commitment to the adjustment of the monetary policy along the lines proposed by the staff in order to prevent the risk of deflation, which is very pronounced in the staff's medium-term assessments of the region.

In more specific terms, the remaining areas of challenge to the regional union remain the following: the fiscal framework that has not worked well for the three largest economies, the demographically-induced slowing of labor force growth and aging of the population, which is becoming an increasing drag on potential output growth; rigidities in the labor market; and a lesser reliance on market-based financing.

On fiscal framework, we agree with the staff recommendation that a fiscal consolidation is needed to prevent the adverse impact on the other members of the region, of the fiscal indiscipline of one or a few members. In this regard, we note that, in recent times, fiscal policy has been pro-cyclical in the economies of the three largest members. In this wise, efforts should be concentrated in ensuring that the fiscal programs of these members are closely monitored and that they comply with the fiscal rules.

We agree with Mr. Portugal and Mr. Steiner's views that to address labor market distortions, and improve intergenerational equity, as well as address fiscal sustainability, both for the short and medium-term, excessively generous benefits currently paid to pensioners must be reduced. In addition, we cannot agree more with their comments on the striking links between population aging and fiscal policy, as well as the disincentives to labor, of financing generous benefits with highly discretionary labor taxes, which threaten fiscal sustainability as population ages.

Finally, with regard to the region's trade policy, while we welcome the decision to reform the Common Agricultural Policy, far more adjustments, especially with regard to tariffs and subsidies would be needed from the EU if it is to be taken serious in its agreement and if it is to be supportive of the economic development and poverty reduction strategies of developing countries in meeting the MDGs targets. In this context, there should also be palpable and sustained policy with regard to market access for the developing countries.

Mr. Ondo Mañe submitted the following statement:

Introduction

We welcome today's discussion on euro area policies in the context of Fund-regional surveillance. We thank the staff for the report accompanied by a helpful selected issues paper. We are grateful to Mr. Padoan for his informative statement.

Recent developments in the euro area have been affected by the slowdown in the world economy, an easing of fiscal policy stance in major european economies, as well as the delay in structural reforms in many countries .With only a gradual economic recovery in the second half of the year, low growth below 1 percent is expected in the euro area in 2003. Despite the appreciation of the euro, the position of exporters does not appear to have suffered. However, structural rigidities in the labor market and insufficient competition in goods and services continue to affect the real sector as a whole. Progress on structural reforms has been slow and major challenges remain, mainly with respect to an aging population and growing unemployment.

Monetary Policy: An Appropriate Policy Response

Developments in the monetary sector are encouraging. The monetary framework has been appropriately accommodating to changes in circumstances and has been conceived to promote growth as well as price stability. In the view of providing a clear anchor to medium-term price stability, the ECB has indicated its inflation objective as "below but close to 2 percent". The evolution of monetary policy seems consistent with the cyclical developments marked by economic slowdown. Indeed, as pointed out by Mr. Padoan in his statement, the recent trends in economic activity and the stronger euro have helped bring down inflation, thereby protecting real incomes. We take note of the staff's proposal that monetary policy should remain accommodative in a context of a slower growth to enhance confidence until a self-sustaining upturn in domestic demand is in place. However, we are interested to know on how effective this should be, given the importance of the supply shocks relative to demand shocks that the staff has raised in the selected issues paper. To that end, we call on the European countries' authorities to pay much attention to the structural issues. Nevertheless, we are pleased to note from Mr. Padoan's statement that the ECB will continue to conduct monetary policy with the aim to maintain price stability.

Fiscal Policies

Although there is a debate on short run requirements for fiscal policy, the fiscal stance for the largest countries is a source of concern. On the one hand, some countries support a tax cut to boost demand while, on the other

hand, the Commission has reaffirmed the need for a fiscal consolidation in the short term to restore confidence and credibility of the Stability and Growth Pact (SGP). In our view, given the medium term challenge posed by the aging population (addressing the fiscal implications of the aging population) and the need to restore the viability of the pension system, actions plan to restore the fiscal discipline in the short-run is needed. This adjustment should not exceed a period of two years. Otherwise, different degrees of fiscal credibility among members would send wrong signals to the new countries that are to join the union. We concur with the staff that any delay in the pace of consolidation in 2004 needs to be compensated for by credible commitments to meet the SGP standard. We also believe that, as soon as circumstances will permit, with a rebound of the global recovery expected next year, the countries should take strong measures to restore fiscal discipline.

Structural Reforms

While we note that over the last years, important strides have been made in making product markets competitive, reforms of the labor market at the national level have stalled. For the EU to be competitive in the global economy, it is essential to set a new framework for reform in this area for years to come. As regards the product markets, it is regrettable that remaining barriers to cross-border trade continue to be hampered by obstacles to liberalizing in the internal markets for services. On financial services, we encourage the European authorities to press ahead with the remaining reforms to cross-border clearing and settlement and to forcefully implement the Financial Service Action Plan (FSAP) and the Risk Capital Action Plan.

Regarding the labor market, the aging of the population in Europe makes structural reforms urgent. These reforms should focus more on out-of-work benefits. Moreover, since Employment Protection Legislation (EPLs) makes firms reluctant to hire workers and , thus, represents a major impediment to curbing unemployment, we concur with the staff that comprehensive reforms of EPLs should move on to the agenda in most countries. On pension reform, we note that aging population will create a growing imbalance in public pension systems. We also concur with the staff that reforms, including “parametric” reforms, are most welcome and that there is a need for developing private pensions pillars in most European countries.

Trade Policy

We are pleased to note from Mr. Padoan’s statement that the EU considers the conclusion of the Doha Development Agenda to be particularly important in order to boost global economic growth and development opportunities. We also welcome the joint framework paper presented in August by the EU and the United States that recognized that the poorest countries needed special treatment in freeing trade of agricultural goods. Still,

we call for the elimination of subsidies on agricultural products and the augmented access of developing countries' products to markets in advanced economies..

The recent decision to reform the Common Agricultural Policy is a welcome step. As noted by the staff, the partial decoupling of subsidies from production levels is a central feature of the reforms. However, we are of the view that also in this area, a lot remains to be done. It is regrettable that reforms in sectors important for developing countries are not receiving the urgent attention that they deserve.

We agree with the staff that creating a multilateral trade environment supportive of economic development and poverty reduction would require the EU to set targets that are far more ambitious. We also hope that the EU's regional arrangement for the ACP countries will be maintained.

In conclusion, we hope that the euro area authorities will take the necessary collective measures to foster growth, including the removal of the existing structural rigidities to contribute to a healthy rebound in world economy as well as to pave the way for sustained development and poverty reduction in low income and other developing countries. Hence, we expect the next consultation on euro area policies to be concluded on a more upbeat note than today.

We welcome the EU's assistance to low income countries, in particular their continued commitment to ODA to the poorest countries especially to sub-Saharan African countries. With regard to the euro area and the CFA countries, we are of the view that the pegging arrangement between the CFA franc and the euro has served the countries well. We are appreciative of this excellent collaboration.

We wish the European authorities success in their challenges ahead.

Ms. Indrawati submitted the following statement:

At the outset, we would like to commend the staff for the concise and well written set of papers. We also thank Mr. Padoan for his excellent statement on behalf of the euro area member states. The staff report provides a general overview that despite many efforts in addressing some rigidities, in particular, labor markets and financial sectors, the growth performance of the euro-area remains disappointing. Progress in the implementation of key structural and fiscal reforms by the national authorities has been mixed. This phenomenon indicates that structural rigidities still exist in the euro area.

Although cyclical factors have contributed to the weakness of economic activity in the euro area, slower growth in the euro area could also

be associated to the lack of structural reforms and fiscal consolidation in recent years. As the economic performance and budgetary condition across the member countries in the region have been uneven, it has created a divergence in views among the member countries in adopting structural and fiscal measures.

We are pleased to note that there are encouraging signs of recovery in the euro area for the second half of this year. The region has been relying on external demand to support its economic activity. Given the main source of growth is net-exports, the persistent appreciation of the euro will inevitably weaken net exports, reduce profit margins of exporters, and dampen growth. Hence, sustaining economic growth in the euro area will also require a strengthening in domestic demand, which also calls for a reduction in the structural rigidities.

On monetary policy, we commend the ECB for its skilful monetary management which is deemed appropriate in light of the current economic conditions, as well as the outlook for price stability in the medium-term. We note that a sound monetary policy aimed at maintaining price stability has become the principle which forms the foundation of the macroeconomic framework in the euro area. In this regard the ECB's clarification of its inflation objective as being "below but close to 2 percent" is very important.

In view of a slower growth prospect and that the risk of undershooting the inflation objective is greater than overshooting it, and also as the risk of deflation is very low, we concur with the staff that monetary policy should maintain an accommodative stance to support confidence until an upturn in domestic demand is entrenched. We believe that there remains a considerable room for the ECB to lower interest rates.

While monetary stimulation is welcome in the short run, using monetary policy alone to accelerate growth to above a sustainable level will simply result in increasing inflation, instead of achieving higher economic growth. Hence, the EU countries need to adopt a comprehensive macroeconomic policy framework including prudent fiscal policy and undertake more rigorous structural reforms that ensure sustained and non-inflationary economic growth.

On fiscal issues, we note that compliance with the common fiscal rules by several countries in the euro area was not satisfactory, with some of the member countries continuing to breach or expecting to breach the deficit reference value of 3 percent of GDP this year. While some countries in the region argue that the weak domestic demand requires at least a neutral fiscal stance—although they will have to repeatedly breach the EU deficit cap of 3 percent of GDP—others argue that the weakening fiscal conditions will damage confidence which is necessary to sustain growth in the medium-term.

The staff has rightly pointed out that the main challenge for the euro-zone is to strike the right balance between sustainability in the longer-run and supporting economic activity in the short-run.

It is regrettable that a number of countries did not sufficiently consolidate their public finances when economic conditions were favorable. It is even more challenging for these countries to forcefully implement the necessary budgetary consolidation measures as their policies recently were focused more on boosting domestic growth. While we agree that the cyclical factors in the euro area have to be balanced with longer-term sustainability of public finances, we also perceive the need for fiscal easing, or at least a neutral fiscal stance, to help accelerate economic activity which is crucial in the short term. For the medium- and long-term, we broadly concur that credibility is important in order to built confidence in the macroeconomic framework in the euro area, and hence, restoring compliance with the common fiscal rules and the Stability and Growth Pact is essential. The automatic stabilizers, in this regard, should be allowed to operate fully around the consolidation path, in order to strike the balance between short- and medium-term objectives.

To achieve the economic growth close to its potential level and to sustain it in the medium-term, more forceful structural reform is also required. We note that many countries in the euro zone have tried to pursue structural reforms, combined with fiscal consolidation and wage moderation policies in response to the adverse conditions confronted by the euro-zone since the 1990s. However, in the larger countries, the pace of such structural reforms seem slower, and hence, did not contribute notable performance. We believe that more flexible and efficient product and labor markets are urgently needed to help increase potential growth and employment and to improve economic resilience.

We are encouraged by the recent reforms in labor and product markets, as well as pension funds. However, we were concerned by the demographic shock faced by the region. It implies a decline in the potential labor force and an aging population which may result in a significant decline in potential output growth and adversely affect public finances (illustrated in Box 2 of the staff report). Hence structural changes in the labor markets and the social security system are becoming more urgent. Unfortunately, commitment of the countries to pursue the politically sensitive challenges has weakened and the pursuit of vital reforms has slowly moved off the agenda.

Turning to the regional trade policy, the regional surveillance covering trade policies has become increasingly important, not only for the euro area, but also for other countries outside the region as these countries may be affected by the regional trade policies. In view of this importance, the staff report would have benefited from a broader and deeper analysis on the trade

sector, in particular, the discussion on trade barriers including subsidies in the euro area. This is also the key area where the structural reforms need to be pursued in order to enhance the growth potential and contribute to global economic growth. In this regard, the European Union should cut the hefty subsidies extended to their farmers and open up their agricultural markets as the EU spends billions of dollars every year on subsidies to farmers and to lower imports barriers on certain farm goods.

Mr. Scholar and Ms. Stuart submitted the following statement:

We found today's papers comprehensive, rigorous and candid. The documents clearly identify the main policy challenges facing the euro area and we agree with most of the staff's analysis and conclusions.

Short-Term Outlook

Euro area activity stalled in the first half of the year and growth forecasts have been revised down. But there are now some more encouraging signs, with a number of the forward looking confidence indicators showing a modest pick-up, equity prices rising, the effects of monetary easing starting to be seen and improved prospects for external demand. These developments appear likely to feed through into a recovery in the second half of the year. We agree with the staff, however, that the recovery is likely to be gradual, given the modest nature of the downturn, the constraints on fiscal policy, the appreciation of the euro and the ongoing adjustments to corporate balance sheets and employment. Furthermore, while the risks to this outlook have become more balanced, key uncertainties remain. In particular, we are concerned that weak employment could hold back consumption growth.

Monetary Policy

The central aim of monetary policy should be to provide price stability and, through this, to support high levels of growth and employment. We agree with the staff's assessment that the ECB's has responded appropriately to developments this year. Given the evidence of diminishing price pressures and the weak growth outlook, an accommodative stance for monetary policy remains appropriate.

We support the conclusions of the ECB's recent review of its monetary framework and welcome the ECB's approach towards increasing openness and transparency. These changes will be key to ensuring accountability and in maintaining the confidence of the general public and financial markets.

Fiscal Policy

The UK's views on fiscal policy frameworks are well known. Any framework must provide for the sustainability of public finances; must allow for the impact of the economic cycle; and should also take into consideration the quality of public expenditures, including public investment. Given this approach, we support greater emphasis on cyclically adjusted budget positions and agree with the staff that automatic stabilizers should be allowed to play freely where possible.

Looking further ahead, we share the staff's concerns about the long-run sustainability of fiscal policies in many euro area countries, given the pending effects of population ageing. Governments are beginning to address these problems; we welcome the recent steps that have been taken in a number of countries to put in place pension reforms. However, more needs to be done to improve work incentives, increase employment rates and reform public pension schemes.

Structural Reforms

We welcome the increased attention to structural reform efforts. However, there remains considerable scope for further progress to improve the euro area's growth potential and to increase its resilience to shocks. The staff rightly highlight the significant inter-linkages between such reforms and improvements in long-term fiscal sustainability. Continued progress on the Lisbon Agenda of structural reforms will require strong leadership and a clear communications strategy to increase public awareness of the need for these reforms.

In particular, we support the staff's emphasis on the need for greater employment flexibility and product market liberalization (particularly in the service sectors). We also agree on the critical contribution to world growth that could be played by progress on trade liberalization under the Doha Round. Further reductions in trade tariffs and export subsidies would significantly improve efficiency and welfare for European consumers, as well as contributing strongly to poverty reduction and the achievement of the Millennium Development Goals. We hope for a successful conclusion to this week's meeting in Cancún.

Mr. Szczuka agreed with Mr. Portugal and Mr. Steiner on the possibility that the pension reform in the direction of creating privately operated funded pension funds could be considered as unfriendly to the SGP. The issue should be addressed when revising the SGP rules or implementing the SGP rules, in order to focus more on the issues of long-term fiscal sustainability by taking into account complimentary and explicit public liabilities.

On accession to the euro area, staff comments would be appreciated on whether accession was viewed as a challenge for the euro area, or as a potential benefit to the EU in broader terms, Mr. Szczuka continued. There would be economic consequences beyond changes in the voting procedure of the ECB as mentioned in the staff report. There was also the issue of how FDI and trade issues would affect accession countries as compared to current members of the Union. Finally, staff comments would be welcome on potential labor movements from accession countries to current members. Even though those movements were likely to be small, they could have a significant economic impact.

The representative from the European Central Bank (Mr. Wijnholds), made the following statement:

> I would just like at the outset to make a few remarks on behalf of the ECB on monetary and exchange rate policies. Most of the statements seemed to endorse the staff's views in these areas, but there are a few who have a somewhat different perspective.
>
> First, there is a sometimes lingering impression that the euro area may be heading toward deflation. Inflation has, in fact, been hovering around 2 percent and has not shown a clear downward trend. For the next year, inflation is expected to be somewhat lower but still close to the quite stable inflation expectations of just below 2 percent. This does not point to deflation in any shape or form.
>
> Second, in one statement doubts are expressed about the credibility of the ECB's commitment to avoid deflation. Since the reason for this doubt is not explained further, it is a little difficult to give a response, but it can be said that the ECB is not only committed to preventing deflation, but that it also has the means to counter deflationary tendencies were they to emerge. Having said that, the ECB does not see this as a risk going forward. I should also emphasize that the ECB has to focus on price and monetary conditions for the euro area as a whole, although it should be noted that for Germany the ECB does not see a deflationary process developing.
>
> Third, with regard to the use of the Taylor rule, it is not a yardstick that the ECB itself follows in particular. As is the case for any other quantitative measure for assessing the stance of monetary policy such as the monetary conditions index, the ECB believes that it is better to look at both measures at the same time. This was the policy followed in the staff report and is favorable to the use of only one measure as was done in the case of the WEO.
>
> On the question of whether the EMU is still something of an experiment while possibly becoming more so as more countries join, I take a different view, and it can be said that financial markets take a different view also. The EMU project had a long period of preparation. When the full-

fledged monetary union's so-called third phase was launched in 1999, it was ten years since the path breaking report on the monetary union had appeared. It is also unlikely that the accession of new members to the EMU might create an existential problem. The ten acceding countries will contribute no more than 6 percent to the EU's GDP initially. We certainly hope that figure will increase, but those are the facts at the moment.

The Director of the European I Department (Mr. Deppler), in response to questions and comments from Executive Directors, made the following statement:

I want to respond specifically to some of Mr. Reddell's comments and then I will address the fiscal issues. Mr. Chadha will deal with the issues on the general outlook, and monetary and structural issues.

Mr. Reddell has suggested that the staff may have not adequately focused upon the broader and more fundamental issues relevant to the EMU area through the Article IV surveillance, in particular the appropriateness of the fiscal framework, whether the EMU will survive, whether flexibility of structures is increasing or decreasing, and whether the staff is sufficiently politically aware of the underlying limitations and constraints. I would like to suggest that, although, the staff did not address those issues as frontally as Mr. Reddell might have wished, the report addresses all of those issues even if only in a more implicit way.

On the question of will the EMU survive, it will, but that is not the issue. The question is whether the EMU will prosper. The EMU is a comfortable environment for countries, and the question is whether that environment is going to spur them to undertake the reforms that will lead to growth. This is upper most in the staff's mind in thinking about policies in the EMU area—how to move toward systems that spur growth, or where the incentives to undertake reforms remain alive rather than dormant especially during good times. In this regard, I would claim that the staff is acutely aware of political constraints and political limitations. The Board has to understand that Europe has strong corporatist roots, and these societies have difficulty dealing with reforms in good times. Instead, they tend to deal with issues when they are front and center. They tend not to have the wherewithal, if not the intentions, to deal with issues going forward in a more benign environment. This is why, in thinking about the viability of the EMU, it is important to look not only at what the issues are today, but also at how the political economy associated with these issues are going to develop over the next few years.

Directors should also be aware of what the Article IV surveillance of the euro area entails, and especially of the gray area in relation to the surveillance of the individual members. When the euro area was created, members surrendered discretion over monetary policy to the ECB and some

other authorities in Brussels. The Fund's view based on the Articles of Agreement was that the conveyance of monetary policy to supranational authorities did not change the surveillance obligation. Thus, Article IV surveillance of the euro area covers those decisions that have been shifted to super-national bodies. Strictly speaking in the case of the euro area, Article IV surveillance thus applies to monetary policy, because this has been devolved to the ECB, and also to trade policies, because the members have transferred authority essentially to Brussels, at least for negotiating trade agreements. At the same time, it was also agreed that surveillance over those activities and on monetary policy in particular, required surveillance over other aspects of policy, including fiscal and structural policies, which while they are policies that are reserved to the nation states rather than commonly decided, they affect the common monetary policy. Moreover, experience shows that area-wide institutions play a considerable role in these fields as well. Euro area surveillance thus includes not only a clear core area but also an area which is national, but still subject to area-wide discussion and vetting. From a Fund perspective, therefore, there is a gray area between where exactly euro area surveillance ends and bilateral surveillance begins, and the staff always tries to be careful in treading that line. It may also contribute to Mr. Reddell's unease about whether Article IV surveillance of the euro area is as thorough-going as he would like.

On fiscal issues, I took the Board to be generally supportive of the staff's position, with some Directors being somewhat more in favor of flexibility than the staff, and a few European Directors in favor of strict adherence to the SGP. There was a remark by Mr. Alazzaz in particular, however, which I thought was incorrect in stating that there is a well known tendency in empirical work to understate potential for growth and to overstate inflation risks. I wish that was the record of the staff. In fact, the staff, if truth be known, has erred in the other direction; we have tended to see supply side constraints as a bit on the looser side than have the authorities, and we have seen inflation risks as less than the authorities have. It is three years running now that the staff has been somewhat more on the accommodative side than that of the authorities, and has been proven wrong. And although I maintain my present position that the authorities should remain somewhat more accommodative, the record is that we have erred pretty consistently in that direction in the past, overstating the potential for growth and underestimating the risks on inflation.

In his statement, Mr. Reddell also suggested that the monetary union needs a fiscal framework. I did not hear any Director disagree that the SGP is an appropriate long-term framework for the monetary union. This is a point that we have discussed in the past, and the fact is that if the demographic problems facing the euro area are taken into consideration, the requirements of the Stability and Growth Pact objectively considered are hard to disagree with. The long-term framework is not the issue; the issue is how to get there. At the

core of the problem, as Mr. Reddell states, is the possibility of getting sovereign states to agree to things which they have difficulty agreeing to. In looking at this issue, however, it is critical to be aware of the history of these countries. The persistent tendency in Germany, France, and Italy is to over promise during upswings and leave the consequences for the downswings. This applies both to fiscal policies which end up being pro-cyclical, and to structural policies which get energized during bad times and lag in better ones. Looking forward, while governments are making promises today to reform in the future, the fact is that in the past those intentions have not been persistently followed up as recoveries proceeded. Whatever the intentions are today, one cannot presume that the political process will deliver adjustment in the future. This is why the staff, while wanting to be flexible, is essentially political in its approach to the issues facing these countries. The staff is essentially in favor of flexibility, but is making that flexibility conditional on clear concrete commitments today to serious reforms that will be carried forward during upswings. In sum, the basic structure of the SGP seems fine, but it unfortunately does not generate the forward-looking behavior that the euro area needs.

Mr. Padoan and his authorities claim there is no trade-off between the timing of consolidation and the quality of consolidation. Frankly, that is not the staff's view. This issue came to a head in the case of Germany this summer, where the record shows that the quality of the fiscal adjustment undertaken in 2003 was poor. The bulk of the adjustment was not oriented to achieving longer term goals. As regards 2004, I view the proposed tax cut essentially a political measure that opens possibilities for higher quality policies going forward. There is a trade-off facing these countries in terms of the timing and quality of the adjustment they face, and this is something which the SGP authorities cannot recognize because the rules are against them. On a related aspect, Mr. Kremers made the point that the SGP promises fiscal sustainability. His authorities' actions testify to that statement. The Netherlands has just embarked on a four-year fiscal consolidation effort which is meaningful, is pre-committed, and does have upfront consolidation, but his authorities are an exception in this regard. The ability of other countries to make forward commitments of that nature is simply not there historically, except for tax cuts. Authorities are willing to commit to tax cuts going forward, but the expenditure reductions to pay for those tax cuts are not there. Thus, while I am sympathetic to where Directors are coming from, the reality is that, if forward-looking and durable adjustment is desired, there is a cost that will have to be paid in terms of the pace of consolidation today.

In approaching the bilateral Article IV consultations coming up in October, it is important for Directors to bear in mind that the monetary union itself has implications for the situations countries face today. Some countries benefited from monetary union; the smaller countries were very forward-looking in their approach to monetary union, and they got their house in order.

By the same token, many of those same countries also benefited from the monetary expansion which made fiscal consolidation easier. Those countries should bear in mind that the situation they faced is a bit different from the situation others faced. Germany, for instance, was not one of the winners of the EMU process, and has been coping with the difficulties ever since. There is a need to appreciate that fact in thinking about the situation in Germany. It is important not only to think about whether the rules are always uniform, but how the rules should be applied taking into account how the EMU itself is impacting countries.

On narrower questions concerning fiscal policy, the notion of letting the automatic stabilizers take effect seems to be accepted by all Directors, whether from the euro area or otherwise, provided problems with the 3 percent limit do not arise. There was also a question on progress with regard to tax harmonization and tax cuts. There are no rigid requirements toward complete harmonization. Moreover, directives on taxes require unanimity, which means that in terms of harmonization at EU-wide levels, progress is slow. The most recent issue of note are the initiatives regarding the taxation of savings. These are in principle resolved within the EU, but contingent on achieving agreements with key non-EU authorities. Those issues remain to be solved. There are always a variety of issues with regard to taxation of specific sectors (e.g., energy), but generally speaking, harmonization stems mostly from competitive rather than directive considerations.

Finally, there was a question on why the staff favors cutting spending on transfers and public employment. The reason is because that is where a significant payoff resides not only in terms of fiscal adjustment, but also in terms of the linkages with structural reform, strengthening labor market incentives, and issues of intergenerational equity.

Extending his remarks, Mr. Padoan made the following statement:

First, it should be noted that my preliminary statement reflects an agreed upon statement of all EU members therefore it should be clarified that there is not a distinction between my position and that of some European chairs as far as the assessment of the fiscal framework is concerned.

Second, with regard to Mr. Reddell's use of the word "experiment" when speaking about the EU and EMU, if the history of European integration is analyzed over the last century, ongoing experimentation has occurred which deals not only with monetary and fiscal issues, but a range of issues. In that respect, I note that this process of experimentation is forcing the staff to experiment on a surveillance exercise which has to deal with inhybrid authority, if I can use that expression. That is the strength of the process of European integration, as opposed to a weakness, although of course the

concerns raised by Mr. Reddell are at the center of an ongoing debate, including the debate on the constitution.

Because of this process of experimentation, I continue to hold the view, that the issue of trade-offs between short-term constraints and long-term achievement of sustainability of public finances in Europe still has to be clarified. From a positive point of view, Europe is in a phase of experimentation, and it remains to be seen what the results of these short-term tensions in keeping with nominal constraints will be in connection to growth-oriented policies. This theme is very much a part of the Lisbon strategy, which is now being given more substance within the broader economic policy guidelines. My suggestion to colleagues at the Board is that the euro area still needs sometime to assess how the institutional changes of EMU will develop.

On the SGP, the staff report notes the possibility of special circumstances in a situation of weak growth would justify deviations from the 3 percent rule. I would like to clarify to colleagues that the SGP does not explicitly mention any special circumstances, but rather alludes to the exceptional clause which allows reconsidering the 3 percent target when growth is not only weak but negative. This clause refers to the possibility that there is a downturn of at least 2 percent in one specific year, and in any case this possibility should not be considered unless growth is negative by 0.75 percent.

In response to Mr. Szczuka's questions on accession, there was a working paper on this issue circulating last fall, and the outcome was that essentially there are too many people at the table, so to speak, and there is not much more the staff can comment on that score. On the issue of the friendliness of the SGP to pension reform, I would underline the point made in the Selected Issues paper asking whether it is credible to be down scaling pension benefits under the public pillar without making provision for people to increase their savings in nonpublic pillars. Given that the aging population is going to be a political majority, something needs to be done this respect. Mr. Szczuka has adeptly asked this question because his authorities are in the midst of this process, which has the implication of raising his authorities' fiscal deficit in relation to the Maastricht target. From the savings and investment point of view, there is a point where this is simply a transfer of savings from one institution to another, and it does not affect the macro balance. Therefore, the question arises as to why it should be taken into account when thinking about the SGP. The staff is preparing a paper on the macro dynamic issues associated with euro accession, which we hope to have for Directors sometime in the early fall of 2003. There are a number of issues that come up there which are pertinent to the relationship between the existing and the new, forthcoming members of the EU.

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

On recent developments in the outlook, a number of Directors had questions relating to the state of corporate balance sheets in the euro area and the corporate banking sector nexus. First, there was a question about what the indications are that adjustment in the euro area has been slower than in the United States. Unfortunately, the first point that has to be made is a data issue. The United States publishes very timely quarterly flow of funds data on the corporate sector, and that data shows clearly that in 2002, financing gaps closed, and they closed very quickly after the bubble burst. For the euro area, by necessity, the assessment that the staff have is a projection based on country data put out by the market, such that the data we have are best estimates suggesting that adjustment has been slower. There is a fairly striking contrast between the adjustment of employment at the firm level with employment in the euro area continuing to grow late into last year. There has been an update on employment, which is reflected in the aggregate lack of absorption of new entrants into the labor force. This constitutes more anecdotal evidence that corporate restructuring of the euro area has been much less aggressive than it has been in the United States or even Japan.

There were a number of questions on the role of the banking sector and the corporate banking sector nexus. I would first point out that it is not the staff's view that one banking system is necessarily better than another. The point is that there are differences, and they have implications for the speeds of adjustment in response to shocks. It is well known that capital markets react quickly to bad news and perhaps too quickly, whereas banks have traditionally maintained relationships and take a longer term view. There was a pointed question as to whether the staff think that the structure of banking system in the euro area had resulted in excessive forbearance during the recent downturn. This is not the staff's view; there is clear evidence that there has been corporate restructuring. The point to be made is the speed at which that restructuring has happened, and the it is ongoing in the euro area as opposed to he United States.

On corporate balance sheets, there was a question about whether the completion of corporate balance sheet adjustments in the euro area could be expected to lead to a resurgence of capital flows as seen in the early years of EMU. The staff remains skeptical. Much of those capital flows corresponded closely with the building up of the equity bubble and a the mergers and acquisitions taking place at that time. It is unlikely that the stock market will rise to similar levels or the same kind of boom occurring. There should be some pickup in FDI, but it is important to remember that a lot of that FDI is still hurting in the euro area because of the movement in the euro.

On monetary policy, there were some questions about the ECB's inflation objective with some Directors asking for the staff's view on the rationale for the 2 percent inflation target. This issue was analyzed extensively in last year's consultation, and there is a substantive Selected Issues paper on the subject which has also been issued as a Fund working paper. One year ago, the ECB's inflation objective remained simply below 2 percent. The staff's recommendation was that the ECB should aim for the upper end of that range. The revision of the strategy they have made and its announcement is in line with what the staff suggested.

There were some comments that an alternative inflation objective would make the ECB's objective more symmetric. As a point of clarification, in the staff's view, the ECB's current inflation objective is symmetric. It is symmetric around 2 minus X, with a little bit of uncertainty what the X is. It is a small number. Historically, there is a concern about the symmetry of the ECB's objective when it was defined simply as below 2 because it was unclear where in that range it might fall. The staff see any potential asymmetry as having disappeared in the new definition. There were questions about long-run inflation expectations which are not reported in the staff report or mentioned in the supplement, but I would point out they remain stable at around 1.8 percent, just below 2.

As a point of clarification on the current stance of monetary policy, it is the staff's position that monetary policy maintain an accommodative bent, by which we mean a sustained easing bias. Our reading of the ECB's position is that it is on hold in a wait-and-see mode, and this view is what is reflected in market expectations. There were comments that suggested the ECB is maintaining an accommodative bent, which is not the case.

There was a question about the buildup of liquidity and the monetary overhang and concerns whether this was a reason for going slow, or being hesitant, in cutting interest rates by more. The staff broadly share the ECB's diagnostic on the causes of the buildup in liquidity. First, the low interest rate environment has resulted in a shift along the money demand curve increasing the demand for money. Second, there probably has been an increase or a shift in the money demand curve because of the bursting of the equity price bubble and the ensuing volatility. The staff do not see this as a cause for concern going forward at this point, but nonetheless should be monitored. The staff fully endorse the ECB's two pillar framework, including the revision that monetary aggregates are to be used to look at long-run or low frequency developments on inflation.

On structural issues, there was a question on whether enlargement could provide relief for the aging problem and its implications for the labor force. I would make three points here. First, legally, the accession countries have a 5- to 7-year transition period option before fully acceding to labor

market mobility. Many of these countries can be expected to take this option, so there should not be much labor movement, or at least less than one could expect. Second, survey evidence on the propensity to migrate indicate an extremely low propensity. For example, even if the legal option is not taken, it would result in migration flows of well less than 1 percent of the current EU's labor force by the year 2010. Third, the population in the accession countries is also aging, so there is on the whole little reason to expect much relief.

There was a question about whether relief with regard to the aging population and the labor force might come from investment. It is important to keep in mind that capital labor ratios in Europe relative to the United States and many other countries is already high. Over the last few years, as labor market reforms have progressed, there has been a de-accumulation of capital in a relative sense, or a resubstitution of labor for capital that was excessive. Reforms need to generate higher long-run potential output growth, which in turn would be the main engine for increased investment.

There was a question about the data presented on productivity for the 1990s and going up to 2000, which masks the up tick in productivity growth in the United States in the late 1990s. The staff was not trying to hide that up tick in productivity. Productivity growth in the euro area has slumped over the last few years, so it has fallen below trend while in the United States it is up relative to trend. It is important to look at the productivity numbers both in the United States and the euro area from a much longer perspective in terms of looking forward, and what the staff have seen over the last 50 years is that Europe has improved much faster. This improvement was primarily a process of catch-up which is now largely complete. The projection going forward for Europe would be fairly slow in comparison. The point of our analysis was to highlight the main reasons for the difference in GDP per capita are differentials in labor utilization rates rather than productivity.

On corporate accounting standards, after the Enron debacle occurred, the response in Europe was that the ongoing FSAP review directives would address many of the corporate governance concerns in Europe. Most of those directives have been adopted, and Directors should take note of Mr. Padoan's statement about an action plan on both corporate governance and external audits.

Mr. Bischofberger made the following statement:

We broadly share the staff's conclusions and recommendations. Furthermore, we fully associate ourselves with Mr. Padoan's statement and I would like to thank him for the clarifications he made this morning. I shall therefore be brief and limit my remarks to just a few additional observations and comments.

While we appreciate the frank and candid tone of the report, which is in line with our understanding of how surveillance should be conducted, we also note that political remarks regarding Germany are widespread and extensive in the report and also in the draft public information note. For example, I am afraid Fig. 2 may leave the reader with the impression that the problems of the euro area have basically one root cause: Germany. Frankly, while we do not question the analysis and while we are aware of the limits of a technical language, we find the heading of this Fig. 2, Germany versus the rest, as not terribly sensitive.

Let me add for clarification and to put things into perspective that we clearly do accept the idea that in the context of surveillance of the euro area, systemically important countries like Germany should be subject to enhanced scrutiny to the extent this analysis is relevant for the region as a whole and covers primarily policy areas which are no longer under the responsibility of national governments. At the same time, as noted by Mr. Duquesne, forthcoming Article IV consultation discussions provide the opportunity for in depth examination of country specific issues. We look forward to address issues related to Germany, including the issues discussed in the context of Fig. 2, and including the question of whether fiscal consolidation efforts in recent years were appropriate in our Article IV consultation discussion now scheduled for early November. I take note of Mr. Deppler's earlier remark that there are gray areas between bilateral and multilateral surveillance. I would prefer to call this area an overlapping area.

That said, and without going into detail, I would like to emphasize that in recent years, Germany, like other European countries, has introduced major reforms in the tax system, the pension system, the labor market, and in the financial sector, partly in election years, and partly against strong opposition from vested interests. I mention that because I would like to make the point that we do not share the report's rather skeptical or even pessimistic outlook with regard to my country at the end of paragraph 11 and also in paragraph 51. In the same vein, I strongly support the point made by Mr. Padoan that in contrast to what is said in paragraph 12, structural reforms have not been removed from the European policy agenda. That said, I would like to add a few comments on specific points raised in the report.

On the short-term outlook, we agree with the staff's view expressed in the supplement to the main report, that recent indicators of recovery in real economic activity have been encouraging. In addition, as also noted by Mr. Padoan and Mr. Duquesne and others, the expected gradual rebound of growth in Europe will be favored by such factors as low interest rates and inflation rates, and sound household balance sheets. We very much welcome the comparison of per capita GDP growth in the euro area and the United States contained in paragraph 8. The staff point out that from a longer term perspective, the euro area's low growth rates reflect in large part low

population growth, and the differential in GDP growth virtually disappears when viewed in per capita terms. In addition, it is interesting to note that productivity growth per man-hour was even higher in Europe on the average between 1990 and 2000. However, we concur with the staff that there is further scope for raising the level of potential output over the medium term, including by making better use of labor resources. Therefore, further labor market reforms are key.

Finally, we note that the language on the likelihood of deflation in Europe gets even more cautious. This is welcome and adequate. We share the staff's view that in the monetary union, despite the fact that monetary policy instruments are not available for individual countries, it is very unlikely that deflation could become entrenched as long as the area-wide price level is rising. Therefore, we continue to believe there is no risk of deflation in Germany as also mentioned by Mr. Wijnholds.

Ms. Gust made the following statement:

It should come as no surprise that my Canadian authorities have asked me to convey the same basic messages we have given on the topic of euro area surveillance over the last couple of years. First, like the staff we are of the view that fiscal policy should respect the Stability and Growth Pact but in a pragmatic way. Second, on monetary policy, my authorities share the staff's view that with hard data on economic recovery in the euro lacking, monetary policy should maintain a sustained easing bias until a self-sustaining upturn in domestic demand is in place. However, as noted by the ECB president, Mr. Duisenberg, in Calgary last Friday, monetary policy cannot by itself generate lasting and sustainable growth and employment in the euro area. This leads my to my third point: that continued efforts to implement reforms in labor and product markets are required to improve economic efficiency and raise the level of potential output in the euro area. With these broad statements out of the way, I would like to give a few detailed comments on fiscal and monetary policy, structural reform, and trade liberalization.

On fiscal policy, there is nearly unanimous consent that fiscal consolidation will be required in the medium to longer term in order to deal with the demands of an aging population. There is much less agreement, however, on what should be done in the short term. As noted by Ms. Indrawati, it is regrettable that a number of countries did not sufficiently consolidate their public finances when economic conditions were favorable. The main challenge for the euro zone is to strike the right balance between respecting the SGP medium-term norms and supporting economic activity in the short run. We support the staff's view that underlying fiscal adjustment of at least half a percent of GDP per year should remain the standard. However, like the staff, we see scope for allowing fiscal adjustment in 2004 to fall short of the standard, but only if budgets include well-specified, quality longer term

measures, that add up to gross savings of half a percent of GDP, such as through quality expenditure adjustments.

On longer term issues regarding the fiscal framework, we appreciate the staff discussion in the report of whether annual nominal flow deficit limits are necessary, and whether the 3 percent deficit ceiling is too tight. Further, Mr. Deppler's frank comments at the beginning of the meeting on this issue were informative and welcome.

For monetary policy, my authorities welcome the clarification to the framework articulated by the ECB. However, like Mr. Le Fort and Mr. Franken, they see merit in having an inflation target within a target band. This would help signal that monetary policy reacts in a symmetric fashion to inflationary pressures, both above and below the target. I thank Mr. Chadha for his clarifying comments on this subject and will pass them on to my Canadian authorities. Targeting a core measure of inflation which excludes the effects of the most volatile prices could be helpful in avoiding the need for explanations of temporary deviations in inflation due to transitory factors. We found the Selected Issues chapter on inflation persistence very interesting, but given the finding that inflation persistence in the euro area is not significantly greater than in the United States, it seems somewhat difficult to justify the ECB's less aggressive stance in its monetary policy compared to that of the Federal Reserve. Though the staff find the ECB has been more aggressive than Taylor rules would have suggested, we recommend treating the results from the Taylor rule simulation with some caution; given that Taylor rules use historical data, the bursting of the equity price bubble would not be captured.

On structural policies, like the staff, we agree that the overall record of implementation has been disappointing. It was encouraging to read in the report that there was strong agreement on the urgency of labor market reforms. The table on page 27 which compared potential output growth under different reform scenarios was particularly compelling in showing that even in the most ambitious reform scenario, potential output growth would decline through 2020 given the long lags in affecting increases in participation rates.

Like last year, we would urge EU member countries to not only implement labor market reforms as quickly as possible, but to continue to press ahead on product market reform and other reforms such as pension reform. The Selected Issues chapter on aging and the SGP was particularly interesting, not only for showing the magnitude of financing required to deal with the pending demographic shock, but also for including the section asking whether there is an information gap on pension reform. It was particularly striking that only a minority of the respondents seemed to understand how a pay as you go pension system works. Few respondents had a clear idea of the relevant pension contribution rate. While we agree with the staff that more and better information may not necessarily break the reform gridlock, more

information is always preferable to less. We support the staff's suggestion that the provision of regular reports on the longer term outlook of public pension finances by credible agencies with no direct interest of their own in particular reform variants could have a catalyzing role.

While we welcome the recent reforms to the common agricultural policy and the statement by Mr. Padoan that the Doha development agenda is currently the EU's number one trade policy priority, we agree with the staff that the reforms fall short of fully correcting trade distortions, and urge EU authorities to continue to make progress on this front. Like Mr. Scholar, we hope for a successful conclusion to this week's meeting in Cancún.

With these remarks, I wish the European authorities every success in the future in addressing the challenges ahead.

Mr. Andersen made the following statement:

I would like to thank the staff for the high-quality reports prepared for the euro area discussion. Also for reasons already referred to by Mr. Padoan, I fully share the comments made in his statement. For the time being, this chair only represents one euro area member, but maybe the Swedish people will ensure that a doubling is reached soon in the referendum to take place this upcoming weekend. I would, however, like to emphasize a few points and comment briefly on the very interesting analysis in the Selected Issues paper.

As mentioned, I concur with Mr. Padoan's remarks on monetary and fiscal policies and also those of Mr. Wijnholds made at the outset of our discussion. As also mentioned by Ms. Gust, it is, of course, unfortunate that not all euro area countries made much better use of the opportunity given by strong growth in the late 1990's and 2000, but it would also be very unfortunate if the sound fiscal framework was not fully respected. I agree with Mr. Deppler that it is important to move ahead also in good times. To prepare for future "rainy days" should always be part of prudent policy making.

The Selected Issues paper provides interesting analysis about long-term issues relevant to the euro area. I would just like to pick up a few issues here. The chapter on inflation persistence supports the view that Europe's macroeconomic problems, especially after the successful disinflation in the late 1980's, do not have their roots in monetary policy but in real rigidities of the economy. Concerning the current slowdown, the chapter on euro area business cycles seems to suggest that the influence of demand shocks is important in explaining the current downturn. However, one has to bear in mind that this "demand shock" quite probably had mainly supply-side origins. Thus, it is not clear that demand management in the traditional sense can ever compensate or neutralize many of the effects of the shock.

Second and, of course, closely related to my previous remarks, I would like to add a few comments on the need for speeding up the pace of structural reforms. The rapid and substantial increase in the dependency ratio poses challenges that require immediate attention and a strong and sustained response in the form of reforms to the pension systems and labor markets. Although the working age population will shrink in the long run, there are unused resources in the labor force due to high unemployment, low participation rates and early retirement that should be exploited better. As the staff point out, there is still a long way to go before the Lisbon target of 70 percent employment rate is achieved.

The calculations provided in the aging chapter of the selected issues paper are very illuminating on the general size of the pension problem in Europe. I would point out, however, that as the projections of economic growth, real interest rates, and future demographic developments are very uncertain, it would be very useful if some stochastic calculations taking this uncertainty into account could be provided. I would think that the discussions on challenges associated with an ageing population would clearly benefit from such additional calculations and analysis rather than to discuss very long run developments on the basis of point forecasts.

It should also be mentioned that rather than cutting pension replacement rates, the reforms in many countries have focused on trying to postpone the retirement age. This seems to be a useful way to proceed in the ”cost-saving” pillar of pension reforms, especially since the life expectancy of old people is much higher today than it was when the present pension systems were established. Having a smaller, but better provided for pensioner segment in the electorate is also likely to be a politically more sustainable alternative than having a large, but poorly paid pensioner class. The considerations would also benefit from taking into account expectations about developments in life expectancy.

The plea for better transparency of the outlook of national pension systems is very important and should be followed up. It must be said, however, that good and established ways to summarize and communicate the outlook of pension finances, including the effects of uncertainty, do not really exist. Efforts in developing good practices to do that should clearly be encouraged

Finally, a few remarks on trade issues. I agree with the staff that the EU has a central role in ensuring a successful outcome of the Doha round, especially with regard to agricultural liberalization. The recent reforms of the CAP that partly separate subsidies from production levels are a step forward. It is essential that all WTO members commit themselves to phase out all forms of export subsidies. Increased market access is most important for low-cost producers in developing countries and the multilateral approach to trade liberalization should be preferred. Preferential access for poor countries to the EU market should be seen as a transitional form of support on the road to freer trade in agricultural products.

Mr. Kanaan considered that, with regard to Mr. Al-Azzaz's statement on growth projections and inflation projections, it was true that in the past the staff had been rather optimistic with regard to projections on growth, and that the framework used in the past was mostly a Keynesian framework in which output was demand determined. However, Mr. Alazzaz was talking about potential growth, and in particular the box in the staff report entitled, "Shadows on Longer Term Performance." It did seem the projections were rather bleak based upon a declining working age population level. A key assumption there was that the capital labor ratio would be constant. If the reforms advocated in the paper were implemented, an increase in the rate of investment, and also an improvement in the quality of investment would lead to a rising capital to labor ratio, which would temper some of the effect of the working age population growth factor. Thus, the projections as reported in the paper should not be taken too seriously by the public. Those projections did assume an exogenous rate of technical progress of 1.5 percent a year, and did not allow for increases in the rate of technical progress. If the proper role were to be given to policy and the acceleration of structural reforms, growth rates in the longer term could be significantly higher than those outlined by the staff.

Mr. Alazzaz suggested that the staff seemed to be overly concerned about inflation, even in the face of deflationary challenges.

Mr. Martí made the following statement:

> I will be brief, because I concur with the statement made by Mr. Padoan. I would like to make a few minor comments. One, the underlying concern with deflation that is apparent in the Article IV consultation staff report and in a few Directors statements is unwarranted. All the available data does not point towards deflation. Analysts have not been able to see any real danger of deflation with regard to the largest economy of the EMU, Germany, nor with regard to other member countries. Thus, it is difficult to agree with a sustained easing bias with regard to monetary policy.
>
> On fiscal policy, the primary issue is whether fiscal policy could be used to foster a short-term boost to the economy. As Mr. Kremers states, the SGP should not be blamed for the current situation. The current situation is the result of fiscal slippage in during the years of upswing. The SGP is probably not the right framework to solve this kind of problem in the short term, because it is the right framework to prevent these problems from happening.
>
> There is a study by the European Commission study covering the past 30 or 40 years on how EMU countries have reacted in the past by means of fiscal policy to downturns in the economy. It is not clear that countries have systemically resorted to fiscal policy when in a downturn. When countries have done so, the effectiveness of those measures has often not been as expected. This merits some consideration when forming a judgment on the usefulness of fiscal policy to foster a short-run stimulus. Further, the United States grew strongly during years in which it was strictly adhering to a consolidation path, while Japan's efforts in the way of

fiscal policy over the past few years have not changed their situation significantly. Some of the smaller EMU countries, however, who have consistently respected the SGP, are achieving broad growth rates that are above average. Therefore, it is important not to move too fast in forming an opinion on whether the SGP in itself is good or not simply because it may curtail the possibilities of action of the authorities in the short run.

On the longer term growth projections, and the shadow cast by the ageing population, demographics is quite important from the point of view of calculations of potential output in the area. I would only say that demographers are more often than not taken aback by actual events in demography. This is an area where economists are not only poor predictors, but also methodologists as well as demographers. For instance, in Spain, after 15 years in which the number of pupils attending a primary school had grown substantially, during the past 15 years the number had fallen. This is the first year in which abandoned schools have had to be renovated to take care of an increasing mass of young people coming to school. About 60 percent of those pupils are sons or daughters of immigrants. Immigration, which is not a well-studied phenomenon in Europe, may become an important factor in the very near future, and could potentially rejuvenate the populations of Europe.

The representative from the European Central Bank (Mr. Wijnholds), in response to Ms. Gust's suggestion that the inflation band should include a core inflation target, noted that the ECB had chosen the HCPI, the Harmonized Consumer Price Index, as a measure of inflation, primarily because it was understood by the public and effected purchasing power. A core inflation figure would not be as informative, and might even be understood by the public as deceptive.

The Director of the European I Department (Mr. Deppler), in response to Mr. Bischofberger, acknowledged the frequent reference to Germany in the staff report, and that the staff could have been more sensitive in the presentation of those references. Nonetheless, Germany had been an outlier, and when major divergences occurred within the union, they needed to be taken into account. The point was not to single out Germany. Many of the issues facing Germany were part and parcel of the creation of EMU, were surprising to many, and were fundamental in thinking about how to proceed. A number of countries, particularly the smaller countries, although France would also have to be included, had benefited from the advent of monetary union and underestimated the difficulties they would face going forward, simply because monetary union had been a beneficial for them. The advent of monetary union had not been beneficial, at the margin, for Germany. The other countries needed to focus on the fact that circumstances going forward might not be as comfortable. The role of the euro area Article IV consultation was to bring to the fore tensions that emerged within the monetary union, and any reference to Germany was meant in an analytical and objective spirit.

Mr. Duquesne admitted that France had benefited from the monetary union, but disagreed with the impression all but one country benefited from the monetary union. All had benefited from the union in various respects.

Mr. Bischofberger replied that it was not his point to question that Germany might be an outlier in some economic terms. However, the staff paper did not elaborate on why Germany was an outlier. Further, the points made about Germany would be more appropriately addressed in the bilateral Article IV consultation discussion, where issues could be placed into a broader framework of the country as a whole.

The Director of the European I Department (Mr. Deppler), in response to Mr. Duquesne, said that at the inception of EMU, there were ten countries who wanted to achieve EMU that had a big stake in pursuing good policies—including structural policies—both in joining EMU and in making the most of the opportunity to succeed. Germany, on the other hand, simply agreed to join the EMU, and did not feel under the pressure of policies that other countries had to face. The dynamics today were partly the product of those historical dynamics associated with the formation of the EMU.

The Chairman asked if the additional burdens of German unification should not also be recognized as difficulties that had been particular to Germany.

The Director of the European I Department (Mr. Deppler) responded that unification caused an appreciation of the real exchange rate for Germany, and in the context of the progression toward EMU, that real appreciation was not corrected relative to the other members of the EMU. Germany entered the EMU with a higher real exchange rate that in retrospect was not appropriate.

Mr. Bischofberger agreed that both aspects of monetary and political unification should be kept in mind when considering economic developments over the past decade.

Mr. Szczuka argued that, after unification, east Germany started from a much better position than the rest of eastern Europe in terms of economic development. Further, they had received massive amounts of assistance from western Germany, and yet were still a severe drag on the German economy as a whole. On the separate matter of pension reform, the issue was relevant not only for the euro area, but for the surveillance of all Fund member countries.

The Chairman commented that, with regard to Mr. Wijnholds's statement that the accession countries would only amount to 6 percent of GNP of the euro area, east Germany was only 10 percent of total German GDP upon unification. At that time, many in west Germany had predicted that unification would therefore not cause significant economic problems. That turned out not to be the case, and was worthy of consideration as a model for the accession of countries to the euro area.

Mr. Duquesne disagreed with Mr. Deppler that ten countries had wanted the EMU, while Germany merely accepted it to its detriment. Germany had benefited a great deal from the absence of devaluation in a number of countries.

Mr. Bischofberger, in reply to Mr. Szczuka, stated that the repercussions of German unification were still very evident, for instance in the construction sector. Unification was a long-term adjustment process and showed itself in the unemployment rate. In response to Mr. Duquesne, Germany had benefited from the monetary union, but garnered the least advantage in terms of declines in interest rates among other aspects.

Mr. Padoan made the following concluding statement:

> This has been a very interesting discussion on the past, present, and future of EMU. I would like to thank colleagues and the staff for their contributions. Colleagues have offered stimulating comments and points of analysis, and I will faithfully report them to my EU authorities. I am sure these comments will contribute to their work in improving how the EMU works.
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> I would like in particular to thank Mr. Kaanan for the point he made in his oral intervention just earlier on the sources of growth. He is right in pointing out that when we do have to assess the future of potential output growth in Europe, which does not terribly substantial going forward, emphasis should not be put only on increases in the labor force; the Lisbon strategy as a philosophy is based on two pillars, and that is to say potential output in the long term should be improved both by increasing employment participation and on productivity improvements coming from innovation and innovation diffusion. Mr. Kanaan is right in pointing out that the staff could dedicate more attention to that issue, and I look forward to future assessments in that direction.
>
> Second, I would like to thank personally and on behalf of my authorities Mr. Deppler and his team. As on other occasions, the papers faithfully report the state of discussions, and contribute new value-added in thinking and interpretation of this ongoing experiment. This is very much in the spirit of the process of evolving European integration over half a century.
>
> Staff contributions stimulating even when there is disagreement, and I conclude my brief statement by pointing out one element of disagreement which is perhaps more of philosophy rather than on any specific technicality.
>
> When Mr. Deppler says that Germany loses at the margin, I am afraid implicitly that he conveys the idea that the EMU as a monetary union is a zero sum game where there are losers and winners. I do not share that view, nor find it useful in understanding the way forward. There is something that makes participating in the monetary union a positive sum game. Where benefits in the long run might not be evenly distributed, to say that at the margin a country might lose while others gain would be similar to attempting to answer the question as to whether California versus Florida are gainers or losers for participating in the United States dollar based monetary union. I

suggest looking forward, and that approach should be put in a better perspective.

The Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that recent developments in the euro area have presented euro area authorities with many policy challenges. In particular, economic growth has come to a virtual standstill since the last quarter of 2002, with declining net exports and investment, and unemployment is beginning to rise. Moreover, challenges loom ahead, with the demographically-induced slowing of labor force growth and ageing of the population becoming an increasing drag on potential output growth, fiscal sustainability and old-age income security. EU enlargement, while surely of benefit to all concerned, would also be a source of new challenges. Directors were of the view that meeting these challenges successfully will require a sustained shift toward more forward-looking national policies and the vigorous implementation of structural reforms. While adversity had begun to induce such forward-looking policies, notably on the structural side, it is essential that these potentially promising steps be sustained once present difficulties recede.

Directors considered that the recent weakness of area-wide activity reflected a number of shocks, as well as structural rigidities and policy lapses. The shocks include the bursting equity bubble, low business and consumer confidence, reduced external demand, the correction of the euro to longer-run equilibrium levels, and geopolitical uncertainties. Rigidities in labor markets and lesser reliance on market-based financing have in some measure contained the effects of the shocks, but they have also slowed both the post-bubble and intra-area adjustments. As a result, the area-wide stagnation is expected to be overcome only gradually, with growth remaining sub-par well into next year. Directors were encouraged, however, by recent improvements in survey and confidence indicators, which signal a gradual pick-up in growth during the second half of 2003. They saw the risks to the outlook as having become more balanced.

Despite the possible implications of the recent appreciation of the euro for the area's short-term prospects, Directors viewed the appreciation as beneficial on balance, noting that it has helped curb inflation and that the competitiveness of the euro area is back to its long-term average. Most Directors agreed that the euro area has borne a disproportionately large share of the burden of adjustment to a weaker dollar, and called for a more equitable global distribution of any further adjustment burden to reduce imbalances in the global economy and to achieve balanced growth in the major currency areas.

Directors felt that monetary policy has done well and has established its credibility. Policies have been in line with inflation and output developments, and the monetary framework has been appropriately modified based on the experience over the past five years. In particular, the ECB's clarification of its inflation objective as being "below but close to 2 percent" substantially reduces the scope for misinterpreting its objective and provides a clear anchor for longer-run inflationary expectations. Most Directors noted that aiming for such inflation outcomes over the medium term provides scope for inflation differentials across member countries and a buffer against shocks that could lead to area-wide deflation. Directors also welcomed the clarification of the relative roles of long-term monetary analysis and short-term economic analysis in the ECB's anti-inflation strategy. A few Directors felt, however, that the inflation objective is too tight, and that it may be difficult to accommodate high and persistent inflation differentials across countries.

Looking forward, Directors agreed that the ECB needs to guard against downside risks to inflation, noting that inflation pressures have subsided. While the downside risks have become somewhat more balanced recently with the pull-back in the euro, the cumulative effects of weakness in activity, a continued softening of labor markets, and the significant past appreciation of the euro should combine to push headline inflation well below 2 percent by late next year. Directors saw the costs of undershooting the inflation objective as greater than those of overshooting it. Low inflation would not help balance sheet adjustments, and would provide less room for, and hence increase the costs of, relative price adjustments across the area. This, together with the risk of euro appreciation, strengthens the case for monetary policy to maintain an accommodative bent in order to support confidence until a self-sustaining upturn in domestic demand is in place.

Directors stressed the need for forward-looking fiscal policies to improve the quality and ensure the long-term sustainability of the public finances in light of potential fiscal pressures created by population ageing. In this regard, they noted that fiscal developments have not been positive, particularly in the three largest economies where most policies have had a short-term focus and fiscal excesses during the boom years contributed to current difficulties in observing the nominal deficit ceiling. Directors agreed that these developments underline the need for a fiscal framework in the EMU. Directors felt that from a longer-term standpoint the basic parameters of the EU Treaty and Stability and Growth Pact (SGP) are broadly appropriate. Noting the current focus on breaches of the 3 percent deficit limit, Directors stressed that past lapses in fiscal discipline, and not the fiscal framework itself, have been responsible for the limited amount of fiscal leeway in the three largest euro area economies. The ageing of the population requires that most euro-area countries move at least toward underlying balance over the medium term. If they did so, there would be room for the

automatic stabilizers to work, and the 3 percent limit would not be binding aside from exceptional circumstances, which the pact allows for.

Directors noted the potential conflict between the short-term need for fiscal stimulus to boost economic growth and the need for fiscal consolidation to restore the credibility of the SGP and to achieve fiscal sustainability. However, they believed that more forward-looking fiscal policies could provide a bridge to long-term sustainability while permitting greater short-run flexibility. They agreed that the SGP should indeed focus on growth as well as stability, but that growth means first and foremost structural reforms rather than short-term demand management. Within such a framework, Most Directors acknowledged that there is scope to trade short-run fiscal consolidation for credible multi-year commitments to growth- and consolidation-oriented structural reforms, notably by cutting spending and increasing incentives rather than raising taxes. Although it was recognized that this entails credibility risks for the SGP insofar as it implies further breaches of the 3 percent deficit limit. Directors agreed that the standard remains that countries with weak underlying positions should take discretionary fiscal policy actions to achieve an underlying high-quality fiscal adjustment of 0.5 percent of GDP a year. Many Directors agreed with the view, however, that, where underpinned by meaningful gains on the long-run structural and macroeconomic fronts, delays that meet the standard on a cumulative basis, i.e., 1.5 percent of GDP during 2004–06, would also strike an appropriate balance between long- and short-run goals. A number of Directors, though, cautioned against departures from commitments to achieve a steady underlying fiscal adjustment of 0.5 percent of GDP a year.

Directors called for more sustained and vigorous implementation of structural reforms. They noted that while the area's low underlying growth reflects in large part low population growth, there is considerable scope for raising rates of utilization of labor resources and for increasing rates of technological progress and innovation. Long lags in effecting increases in labor force participation rates require early concerted actions to slow—if not reverse—the ageing-induced fall-off in potential per capita growth and deterioration in public finances. In this context, Directors emphasized the importance of labor market and pensions reform. The loss of the exchange rate as an adjustment mechanism within the monetary union, particularly in the context of limited labor mobility, imposes a further requirement on flexibility in goods and labor markets.

Directors welcomed the promising reform steps recently taken in some countries, but emphasized that much more is needed to achieve the goals set out in the Lisbon agenda agreed by the European Council in 2000. Directors were particularly encouraged by progress in creating a single market for financial services. Moreover, the reform process in the larger countries, particularly as regards labor markets and social security systems, has been

revived and, in some cases, progressed beyond earlier expectations. Directors also observed that there is a growing recognition of the largely unexploited synergies to be reaped between structural reforms, improved economic performance, and fiscal sustainability that hold the promise of improving medium-term growth prospects and restoring the credibility of the SGP. However, the agenda of needed reforms is long and varies across countries, while resistance to reform remains strong and is likely to strengthen as the economic situation improves. Directors considered it essential that the new reform momentum not become simply a response to economic adversity but be sustained for many years to come. Directors therefore welcomed the steps taken by the Commission, and endorsed by ECOFIN, to toughen surveillance by making the Broad Economic Policy Guidelines both more targeted and forward-looking.

Directors welcomed the recent decision to reform the Common Agricultural Policy. The agreed "decoupling" of agricultural supports from production will lessen downward pressures on world prices. Many Directors noted that greater commitment to opening EU markets will be crucial to achieving the Doha round objectives, and that creating a multilateral trade environment supportive of economic development and poverty reduction would require more concessions by the EU and other advanced economies to developing countries.

It is expected that the next consultation on Euro Area Policies will be held on the standard 12-month cycle.

4. BENIN—POVERTY REDUCTION AND GROWTH FACILITY—REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA

Document: Fifth Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria (EBS/03/126, 8/27/03)

Staff: Ewenczyk, AFR; Boote, PDR

Length: 1 hour, 15 minutes

Mr. Ondo Mañe submitted the following statement:

My Beninese authorities wish to express their appreciation to the staff for the constructive discussions and advice and to management for its support.

Benin's macroeconomic and financial performance in 2002 improved significantly and remained satisfactory through 2003. Despite adverse terms of trade involving dramatic decline in the world cotton price during the 2001/02, the widening in the current account deficit was consistent with the program thanks to increase in cotton volume. This positive macroeconomic

trend contributed to a robust growth, with a reduced inflation and a decline in the fiscal deficit. In March 2003, Benin met the HIPC Initiative completion point triggers, including the finalization of a full PRSP. The real GDP is projected to grow by 5.6 percent in 2003, and the external current account deficit is expected to narrow to around 7.5 percent of GDP.

On the political front, on March 30, 2003 Benin held legislative elections in which the ruling coalition won a large majority in a contest seen as democratic by Beninese public opinion and the international community.

Performance Under the Program

In the real sector, real GDP in 2002 grew by 6.0 percent driven by abundant cotton harvest. Annual average inflation was contained at below 3 percent. Although the performance in the first half of 2003 was somewhat weak, economic activity remained buoyant, supported by strong growth in the construction, industrial, and services sectors.

In the fiscal area, notwithstanding my authorities' efforts to remain transparent with financial management, some difficulties emerged with respect to the fiscal performance that weakened somewhat during the first quarter of 2003. My authorities recognize that during the elections period most attention was focused on the organization of this event, so that regrettably, there were many weaknesses in the public services management, including customs administration. The authorities also admitted that the elections cost more than projected. As a result, while the structural benchmarks for end-March 2003 were met, the end-March performance criteria on net credit to the government and the overall fiscal deficit, exceeded the program target. As indicated in the staff report, total revenue fell short of the program objectives by 0.4 percent of GDP. Spending for the elections and on public utilities exceeded budget appropriations by 0.3 percent of GDP. Nevertheless, continued progress was made in the social sector, mainly in education and health.

During the second quarter, the authorities forcefully addressed these slippages and were successful in bringing the program back on track. The authorities implemented action plans aiming at rationalizing and improving the management of the Directorate General of Taxes and the Directorate General of Customs. Likewise, to enhance efficiency in monitoring external debt service and externally financed capital expenditure, an action plan was adopted for computerized management system (SIGFIP). On the revenue side, these measures included, among others, combating fraud, monitoring transit to border countries, combating illegal imports of petroleum products, and reallocation of personnel to critical customs checkpoints. As regards expenditures, the government made deep expenditure cuts, particularly in non priority spending in order to allow for increased expenditure on health and

education without jeopardizing the overall budget targets. During the second quarter, revenue improved and exceeded the objectives at end-June with a significant margin, while expenditures decelerated markedly, with the result that the overall fiscal deficit was brought in line with the program budget for the first half of 2003. I should add that the remaining indicative targets were also finally met.

Money, Credit, and the Financial System

Price stability is a key objective of the Beninese monetary policy and this is pursued consistent with the targets set by the BCEAO. Furthermore, monetary policy aims at achieving an adequate level of foreign exchange reserves. In order to achieve these objectives, my Beninese authorities are committed to controlling broad money growth to a rate which is in line with nominal GDP growth and net foreign assets increase. Moreover, they are determined to maintain continued efforts to meet all the WAEMU primary convergence criteria with respect to the Regional Convergence, Stability, Growth, and Solidarity Pact, and stepped–up to comply with the regional nomenclature in the context of the WAEMU common trade policy.

The banking system gained financial soundness as five out of seven commercial banks, representing more than 80 percent of total bank loans, have already met the criterion of the capital adequacy ratio set to 8 percent. The entire banking sector is requested by the authorities to observe scrupulously the current banking regulations and prudential ratios. With respect to the recovery plan for the Continental Bank which is one of the two undercapitalized banks, the government is prepared to sell the state's shares by the end-September 2003. Continental Bank is not anymore under close monitoring by the Regional Banking Commission in 2003 and is ready to be privatized.

The participation of microfinance in helping the poor to get financing for their economic activities continues to gaining ground. The recovery efforts of the Federation of Rural Savings and Loans Cooperatives (FECECAM), the largest of the microfinance institutions will benefit from the government support. The microfinance sector continues to show significant improvement, particularly with a sharp reduction in delinquent claims. The monetary authorities are keen to intensify the supervision of the sector to ensure its soundness.

Structural Reforms

Significant progress continues to be made in the area of structural reforms. Structural benchmarks at end-March with respect to fiscal policy measures were met. As regards the state-owned companies, including the public ginning company (SONAPRA), the electricity branch of the public

utility company (SBEE), the Port of Cotonou, and the telecommunication company (OPT), rehabilitation and privatization process is moving on as scheduled mostly with World Bank assistance. The bidding process for the privatization of the electricity company will be launched in early 2004 with the World Bank's support. In the meantime, the implementation of the action plan for the financial rehabilitation of the company will continue. As regards the Port of Cotonou, the feasibility study is still underway and due to be completed not later than the end of the year, allowing the selection of private operators in the course of 2004. Likewise, the privatization of the telecommunication company is projected to be completed by end-2004.

The process of technical support to the cotton sector experienced cash-flow problems that delayed the actions of the independent agency (CSPR) to oversee seed cotton marketing and assisting the authorities in the sector management and credit recovery. Cotton production is vital for Benin as the sector represents about 80 percent of the country's exports. The authorities' intention is to implement a comprehensive reform of the sector leading to liberalizing and strengthening the capacity of producers, principally with assistance from the World Bank. Already the monopsony of the state enterprise (SONAPRA) has been removed. As a result, input supply has been liberalized, the sector has been opened to private ginners, and the privatization of SONAPRA that has been launched recently is projected to be completed before end-2003.

With respect to the civil service reform, the social consensus on the amendments legislation on a new merit-based compensation system is yet to be reached. During a few years, Beninese authorities were reluctant to replace retiring civil servants, so that in the end, the public personnel have dramatically grown old. In order to achieve the objectives of the reform, the authorities intend to develop a new civil service reform strategy with donors' financial assistance. Pending finalization of the strategy, the authorities have decided to implement a recruitment policy based on the use of fixed-term contracts to replace retiring civil servants who will benefit from a merit-based system although these civil servants are contractual for the time being.

Program Implementation: Remainder of 2003 and Beyond

The authorities' medium-term macroeconomic strategy is directed at achieving strong economic growth in order to reduce poverty. They are determined to implement the objectives of the 2003 program that reflect the basic macroeconomic framework of the poverty reduction strategy paper adopted in December 2002 which broadly remained the same in the MEFP of January 2003. They are also committed to avoiding the policy slippages like those faced during the beginning of the year. To this end, they will continue to implement the fiscal measures started during the second quarter of 2003 while principally focusing on enhancing revenue mobilization, and reducing

nonpriority spending. The government intends to strengthen implementation of action plans to improve the performance of the tax and customs administrations. In customs administration, the focus will be particularly on the application of transaction values to all imports, the monitoring of transit to border countries, the collaboration between customs and the tax departments, and between customs and the import verification company, and combating fraud and corruption in customs.

The authorities' intention is to maintain financial stability by accelerating structural reforms, improving capacity building, and creating enabling environment for private sector development. Moreover, they are keen to pursue public expenditure management reform, improve execution and transparency of public spending and enhance the access of the poor to quality basic services.

Debt Sustainability Analysis

Benin attained the completion point under the enhanced HIPC Initiative in April 2003 and since then has engaged in negotiation with its creditors. A debt–reduction agreement was reached with Paris Club creditors under the framework of this Initiative. In terms of net present value, debt reduction amounts to US$48 million in addition to the US$12 million already obtained within the interim period. My Beninese authorities are grateful to the Paris Club creditors who have agreed to grant an additional debt reduction. They are aware of the difficulties they faced last year when they resorted to nonconcessional loans, and are committed to continuing to strengthen debt management to maintain external debt sustainability. To this end they have established a national debt committee (CNE) which, under the chairmanship of the Minister of Finance and Economy, will draft, implement, and monitor the national debt policy, the analysis of Benin's debt sustainability and the fiscal sustainability.

Conclusion

Since Benin has embarked on the Fund's PRGF-supported program, the authorities have demonstrated their commitment to forcefully implementing all macroeconomic and structural policy measures. For their ambitious budget in the framework of the PRSP for 2004, my Beninese authorities indicate their intention to seek external assistance to finance the gap. Despite their efforts towards poverty reduction, Benin's PRSP shows that the country is facing apparent resurgence of rural poverty, including in cotton-producing areas. Consequently, Benin will continue to count on the international community assistance in form of grants and concessional loans.

In concluding, I would like to reiterate my authorities' call on the Board to grant them a waiver for the missed performance criteria in order to complete this review.

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

We welcome the penultimate review of this three year old PRGF-supported program, under which Benin's' economic performance has been encouraging. Growth has been strong with inflation remaining low. Debt service as well as debt ratios have fallen after the completion point was reached early this year and debt relief provided. As Mr. Ondo Mañe has pointed out in his insightful preliminary statement, the authorities have adequately compensated for the fiscal overrun during the first quarter of this year, by adopting strong measures which have resulted in all the five prior actions for this review having been met. We therefore support the authorities' request for grant of waivers requested as well as for the completion of this review. We agree with the thrust of the well written staff document and will therefore focus on a few issues only.

The authorities have appropriately adopted a three pronged reform agenda for the medium term aimed at sustaining growth and reducing poverty. All the three elements—fiscal consolidation, improving the efficiency as well as the volume of pro poor expenditures and the implementation of the ambitious structural reform program—are critical to reach the PRSP goals. The measures proposed taken by the authorities, to improve the efficiency of tax administration, as well as widen the tax base appear appropriate. We wonder whether the impact of some of these measures may be felt only after a lag, and if so whether this will have implications for the target. We welcome the determined efforts of the authorities to curtail non priority current as well as capital expenditure to protect priority outlays in social spending. We are however not very sure whether the elimination of infrastructure projects, alluded to by the staff would be desirable, specially if these projects are concerned with filling up essential ' infrastructure gaps.' Has the PRSP provided for a prioritization strategy to decide between competing claims from different sectors? The staff's comments are welcome.

We support the efforts of the authorities to strengthen public expenditure management through streamlining budget procedures, putting in place a tracking mechanism for PRSP related expenditure as well as enhancing the quality of poverty related spending. The technical assistance planned to be provided by the Fund in this regard will be timely. Decentralization will be a useful modality to improve the efficiency of health and education expenditure since these services are best provided and managed locally. We are therefore concerned that the 2003 budget provides for an appropriation of only CFA 3.6 billion, while retaining CFA 58 billion of local government expenditures to be centrally managed. While we recognize that

capacity constraints will need to be taken into account, we hope that this process of devolution of financial resources to local governments can be accelerated in the future. We welcome the steps being taken by the authorities to address the shortcomings of the PRSP which were identified in the JSA. The move by the authorities to settle the cross debts between the public enterprises and the government as well as audit the services provided by these enterprises will provide a strong incentive for these enterprises to improve their performance.

The authorities would need to remain strongly committed to the goals of the PRSP to implement their ambitious structural reform program. We welcome the proposal to complete the long anticipated privatization of SONAPRA by the end of this year. In this connection, we look forward to a report on the PSIA of Benin's cotton sector reform by the next review. While we accept the need to complete the divestiture of the state owned bank as well as the public utilities on a timely basis, if necessary the authorities should be allowed some flexibility in the exact time table to enable them to better leverage market opportunities We support the efforts being taken by the authorities to improve governance and fight corruption. While we appreciate the action taken by them mitigate the resistance encountered to the legislation providing for a merit based compensation system, it is not clear why there is a lack of 'social consensus ' on this. Or is it purely the lack of a parliamentary consensus?

Since Benin has reached the completion point and has received debt relief, we agree with the staff that the higher expenditures planned in the 2004 budget, should be adopted only after suitable concessional donor financing has been secured, and the quality of the enhanced expenditure can be assured.

We wish the authorities success in their challenging policy endeavors.

Mr. Martí and Mr. Siman submitted the following statement:

We thank the staff for the paper on the fifth review under the three-year PRGF-supported program and Mr. Ondo Mañe for his helpful preliminary statement.

As mentioned by Mr. Ondo Mañe in his preliminary statement, since Benin embarked on the PRGF-supported program, authorities have demonstrated their commitment to forcefully implementing macroeconomic and structural policy measures. Although Benin's macroeconomic and financial performance during the first half of 2003 showed some weaknesses, the authorities have taken strong measures to put the program back on track. We commend the authorities for the measures taken during the second quarter to address the fiscal slippages and welcome the improvements in the financial sector. We also acknowledge the authorities' efforts to address the

shortcomings of the PRSP and the progress on spending on health and education.

We concur with the staff's assessment that the measures adopted by the authorities in the fiscal area, if implemented forcefully, would enable Benin to meet the fiscal program for 2003. On the revenue side, we welcome the action plans for the tax and customs administrations and we look forward to the Fund's technical assistance mission scheduled for October 2003. On the expenditure side, we are encouraged by the approved cuts in current and capital nonpriority expenditures. Nevertheless, some concerns remain regarding the fiscal impact of the large infrastructure projects under the 2001–2006 Government Action Program, as stated in the PRSP Joint Staff Assessment.

As noted by the staff and by Mr. Ondo Mañe, implementation of the structural reform agenda is of crucial importance for achieving the objectives of the PRSP. We support the authorities' commitment to accelerate the structural reform program and encourage authorities to adhere to the new timetable for the privatization of the public utilities and the state-owned bank. We look forward to the completion of SONAPRA's privatization process before end-2003 but we are still concerned that Benin's strong dependence on cotton exports constitutes a major vulnerability. We encourage authorities to look at alternatives for diversification through the promotion of private sector initiatives and investments.

We strongly support the staff's view that following the completion point under the enhanced HIPC Initiative, a prudent debt management policy needs to be pursued in order to place the external debt on a sustainable course. We welcome the establishment of the national debt committee responsible for the country's overall external debt policy and for annual updates of the debt and fiscal sustainability. We encourage authorities to strictly adhere to the limits on government deficit and continue pursuing external assistance with major donors in the form of grants and highly concessional loans in order to be able to finance the ambitious budget for 2004.

We believe that going forward the main challenge is to identify and understand Benin's main sources of growth, which could lead to a substantial reduction in poverty. In this regard, the staff's comments would be appreciated on the work done in assisting the authorities in prioritizing those policy alternatives that may lead to acceleration on economic growth.

Finally, we endorse the proposed waivers for the performance criteria and we wish the authorities continued success in meeting these challenges.

Mr. Usman submitted the following statement:

Introduction

We thank the staff for their concise analysis of developments in Benin and welcome Mr. Ondo Mañe's helpful preliminary statement. Benin's performance under the PRGF-supported program continues to be satisfactory and the results are broadly in line with program objectives. The authorities took strong corrective measures following some slippages in the fiscal area, resulting in the observance of all structural benchmarks and the prior actions for the conclusion of this review. We therefore support the conclusion of the review. With monetary policy set at the regional level and domestic monetary developments remaining supportive of program objectives, we limit our comments to the fiscal, structural and debt sustainability issues.

Fiscal Policy

Progress on fiscal consolidation is essential for achieving program objectives, the MDGs and overall debt sustainability. We note that fiscal policy was loose towards the elections, a weakness which we observe in many developed and developing countries. We welcome the steps taken to correct the slippages and encourage the authorities to persevere on efforts to address the more fundamental and structural weaknesses in the fiscal area. These include the mobilization of revenue, enhancing the absorptive capacity in the social sectors, reprioritizing expenditures and strengthening expenditure management in general. We welcome the authorities following up on the recommendations made by the Fund's technical assistance mission.

Measures being taken to contain the wage bill are also welcome. However, it is important to ensure that the strategy being adopted is sustainable. Also we are concerned that regular civil servants could feel short-changed if those hired under contracts are enjoying merit increases, as this could lead to labor unrest. In this context, it is unfortunate that the prospects are weak for the National Assembly to pass legislation on a new merit-based compensation system for the whole civil service. We encourage the authorities to intensify their efforts in implementing a more comprehensive civil service reform program

We note that the authorities are making progress regarding the devolution process. Legislation to transfer fiscal responsibilities to local authorities has been adopted as well as plans to strengthen the accounting and reporting framework of local governments. We welcome the intention to settle cross claims and debts between the public enterprises and central government, which will enhance transparency in expenditure management. We also thank the World Bank and the Fund for assisting the authorities in enhancing the system for tracking poverty reducing expenditures.

We note that the staff observe that large infrastructure projects scheduled under the Government Action Program for 2001-06 could crowd out priority spending. While we do not at all encourage white elephant projects in the public sector investment program, we, nevertheless, urge the Fund to exercise flexibility on fiscal restraint where such projects have the potential, in the medium to long term, to generate employment and result in productive sustainable growth. It is unavoidable that large projects have an impact on fiscal policy in the short-term and there is need to be selective and to prioritize. Nevertheless, we also believe that large infrastructure projects could have a salutary impact on growth, poverty reduction and private sector development in the medium to longer-term. We urge the Fund and Bank staff and the donor community to assist the authorities to re-assess and re-prioritize these projects and to explore the feasibility of channeling some grants and concessional loans into financing some of the large projects that have the most positive impact on the economy. The staff's comments are welcome.

Debt Sustainability

Benin reached its completion point in March 2004 and we hope that the country is on the path for long-term debt sustainability. The recently established national debt committee should assist the authorities in pursuing a prudent external debt policy and in undertaking debt sustainability analyses. However, improvement in the balance of payments outlook is predicated on better export prices for cotton. In the past, cotton prices have been volatile, and in most cases, movements have been unfavorable to producers like Benin, as was the case at the beginning of the 2001/02 crop year. Moreover, cotton production remains vulnerable to adverse weather conditions. It is therefore important for Benin to promote diversification and to increase the exports of value added products even within the cotton sector in order to reduce vulnerabilities in the economy. We welcome the staff's comments on the prospects on this effort.

It seems clear that for effective debt sustainability, Benin might have to rely more on foreign aid in the form of grants and highly concessional loans for financing investment projects, especially those which are critical to achieve the objectives of the more ambitious scenario of the PRSP starting in 2004. The key challenge is to catalyze such highly concessional resources and to guarantee that they continue to flow in a timely fashion. This informs the consensus at Monterrey and Johannesburg that, for countries to make substantive progress towards achieving the objectives set at Monterrey, there is the urgent need for the international community to mobilize requisite concessional financial resources.

The case of Benin also reminds us of our recent discussions on Fund involvement in low income countries and the update on the HIPC, PRGF-supported programs and the PRSP, all of which have relevance to the case of

Benin which could be classified as a mature stabilizer, whose progress toward the MDGs and debt sustainability is only feasible with increased reliance on foreign aid. The issue for the Fund to examine is how best to achieve the goal of debt sustainability and graduation from use of Fund resources given that aid is becoming increasingly scarce and its flows are unpredictable. In any case, we believe that for better and durable results, the Fund should examine measures that can help promote small and medium-scale enterprises, achieve economic diversification and increase the export of value addition. Equally, the international donor community should extend a combination of enhanced market access and grant resources to countries like Benin to help such countries stand on their own feet over the longer-term. For the authorities, we believe that adhering to prudent macroeconomic policies, enhancing good governance and implementing reforms in a timely fashion will not only help to achieve program objectives but also help mobilize uninterrupted flow of concessional resources.

Structural Reforms

We hope that the successful completion of the legislative elections and the government reshuffle has ushered fresh enthusiasm to accelerate structural reforms and we urge the authorities to catalyze public support for this purpose, especially in the divestiture process. Public support will be more forthcoming if the private sector institutions established within the context of reforms in the cotton sector operate effectively and deliver according to expectations. There is also need to minimize potential unemployment that could accompany the divestiture process in the telecommunication, ports, banking, utilities and cotton sectors. In the face of budgetary constraints and a civil service reform program running parallel, there is need to help the authorities to mobilize concessional resources to put in place appropriate safety nets so as to enhance the political and social sustainability of these structural reforms. We welcome the government's efforts in supporting the rehabilitation of the microfinance sector, which is critical for access to the financing of small-to- medium-scale enterprises and other businesses in the informal sector.

Regional Integration

It is encouraging that Benin is one of the most compliant members of the WAEMU regarding the regional Convergence, Stability, Growth and Solidarity Pact, including the WAEMU common trade policy. It is important that the design of Fund supported programs in WAEMU members continues to support and reinforce regional integration.

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

At the outset, we would like to thank the staff for the preparation of a well-focused report, and Mr. Ondo Mañe for his informative preliminary statement. We commend the authorities for the satisfactory economic performance under the PRGF-supported program in 2002, with all the quantitative performance criteria and indicative targets for end-September 2002 and end-December 2002, respectively observed. This favorable performance may be seen as having contributed to Benin's strong growth and low inflation. However, during the first quarter of 2003 the fiscal out-turn weakened, due mainly, as noted by the staff, to a less effective customs administration and election-related spending overruns, and, consequently, to the nonobservance of the end-March performance criteria on net credit to the government and the overall fiscal deficit.

In this context, we are pleased to see that the authorities have taken measures in the second quarter of 2003 to address the fiscal slippage and bring the program back on track. We are encouraged by their determination to implement a coherent program in 2003 aimed at achieving fiscal consolidation and to lay the basis for sustained economic growth and alleviation of poverty. We agree with the staff that the strict implementation of the strategy set in the program would contribute significantly to achieving the macroeconomic and social objectives. Therefore, in light of the corrective actions taken by the authorities and since all the measures which were indicative targets for end-June were met, we support the requested waivers for nonobservance of the performance criteria and the completion of the fifth review under the PRGF-supported program. Against this backdrop, some comments for emphasis would be in order.

We welcome the authorities' measures aimed at enhancing revenue mobilization, containing current and capital nonpriority expenditures, and strengthening public expenditure management. Improving the quality of fiscal consolidation is key for sustaining poverty reduction. In this connection, we encourage the authorities to continue their efforts to improve the monitoring of budget execution, streamline budget procedures, and especially, enhance transparency and the tracking of poverty-reducing outlays. Close monitoring is essential to ensure the effectiveness of such programs. It is encouraging, in this regard, that the measures taken in the second quarter of 2003 allowed the government to increase health and education spending, which reached 86.5 percent of the targeted amount for end-June, compared with 59 percent at end-March, without jeopardizing the overall budget targets. We welcome the authorities' intention to continue working closely with the Fund to implement technical assistance recommendations aimed at enhancing fiscal consolidation in line with the PRSP objectives.

We are also encouraged by the authorities' efforts to bring about banks' compliance with the Regional Banking Commission's prudential ratios, which contributed to the improvement in the health of the banking sector. Special attention should be given, however, to lending practices and to loan portfolio supervision, to safeguard asset quality and maintain relatively low nonperforming loan rates. Regarding Continental Bank, we would welcome some comments from the staff regarding the implications of the termination of the close surveillance of its operations before the end of the privatization process. We concur with the staff that the government's support for the rehabilitation of the cooperative and mutual credit institutions and actions towards strengthening supervision of the sector are important, considering the incidence of these institutions in helping to address the financial intermediation problems of a wide segment of the population.

We welcome the authorities' commitment noted in Mr. Ondo Mañe's preliminary statement, to speed up the structural reform program to facilitate a high and sustainable growth and stable macroeconomic conditions. In this regard, civil service reform should remain a priority. We agree, however, with the authorities on the importance of achieving a broad consensus for the approval and implementation of needed legislation. Similarly, carrying out the divestiture program that includes the public utilities and state-owned enterprises as planned, entails potentially significant efficiency gains for the economy, in the context of a larger role for private sector activity. As the staff note, diversification of the economy through the promotion of private sector initiative and investment is key for reducing Benin's high vulnerability to external shocks, given its dependence on a single commodity, cotton, as the main source of export proceeds. Finally, we welcome the creation of a debt committee to help maintain prudent debt-management practices.

With these comments, we wish the authorities every success in meeting the economic and social challenges that lie ahead.

Mr. Andersen and Ms. Zubkova submitted the following statement:

We would like to thank the staff for their well-written paper and Mr. Ondo Mañe for his informative preliminary statement. We are in broad agreement with the findings and recommendations of the staff and can support the proposed decision.

Benin's track record in policy performance during the program has been good, although we find it regrettable to note the weakening fiscal performance during the first quarter of 2003, resulting in that two fiscal performance criteria were not met. Considering the political context in Benin during the first quarter of 2003, we find it understandable that it turned out being very challenging to meet certain performance criteria, even though one is a key criteria as regards poverty reduction. Two elections and en gross

resignation of ministers for various tactical, political reasons left a leadership vacuum that resulted in loss of momentum in many important areas of budget execution and reform. However, it was probably necessary in order to consolidate democracy. Benin has successfully rooted its young democracy a little deeper—in a turbulent time where the sub-region is facing serious trouble—and we can support granting the necessary waiver, also in view of the strong corrective actions taken and considering that structural benchmarks were met.

Despite Benin's generally impressive economic policy performance, to achieve a significant reduction in poverty remains a challenge. In this respect, timely implementation of the structural reform agenda is essential. The improved political stability for recharging the reforms and effectively pursue poverty reduction provides a window of opportunity that should be fully utilized, and we urge the authorities to ensure that the structural benchmarks as well as performance criteria will be observed. We were pleased to notice in the staff paper that despite the policy slippages during the first quarter of 2003, the key macroeconomic objectives for the end of 2003, including real GDP growth, consumer price inflation and fiscal target, could be achieved.

With those general remarks, we would like to underline the importance of the following issues in relation to the review and the upcoming mission:

Visible progress in key areas needs to be achieved in order to enhance poverty reduction. The reform agenda is long in Benin, but has largely remained the same for almost a decade.

The divestiture of public utilities and the state owned ginning company should progress. Divestiture has been programmed for almost a decade and no serious technical obstacles seem to exist. The ground seems well prepared for implementation of the final phase of this long awaited divestiture and the structural benchmarks agreed should prevail.

The importance of building up local governments' absorptive capacity deserves emphasis. Although the 77 new municipal councils have been established and mayors elected, the decentralization reform is not pursued by the establishment of clear criteria and mechanisms for transfers of resources to the new municipalities. Moreover, the cost related to the areas of responsibilities transferred from central government to the municipalities is estimated to equal at least 20 percent of the government's budget. However, actual transfers in 2003 are inferior to 3 percent of total expenditure. This needs to be addressed in the 2004 budget proposal and the 2004–06 MTEF.

Shortcomings of the PRSP need to be addresses urgently. The shortcomings of the strategy are mainly related to the lack of clear immediate objectives and establishment of indicators for the monitoring of the PRSP.

The government has chosen to organize this work under the auspices of the Observatory for Social Change (OCS) and has asked donors to help finance this through a basket funding mechanism for the OCS. However, it seems that only few donors have responded positively. We believe that the Fund should strongly encourage the OCS and a strong national ownership of PRSP monitoring.

Quality of expenditure needs to be ensured. Poverty reduction in Benin can only be achieved if public expenditure is effectively targeted to social sectors and basic infrastructure in rural areas. In this respect, we welcome the authorities' increased use of autonomous agencies in the implementation of projects as well as realization of the action plan on the computerized expenditure management system by end-September this year. At the same time, we would like to point out that the 2003 budget does not sufficiently reflect the PRSP and should be more ambitious. We underscore the very exceptional circumstances allowing for this year's waiver and urge the authorities to eliminate the non-priority outlays. The principal constrain in Benin as regards achievement of PRSP objectives seems to relate to absorptive capacity regarding priority social spending.

The ambitious scenario of the PRSP should be pursued. We agree with the staff that the budget for 2004, which commits higher expenditure to priority sectors, should be adopted only after concessional financing consistent with the objectives of debt sustainability has been secured and absorptive capacity regarding social spending has improved. At the same time, we find it important that the more ambitious alternative scenario of the PRSP starting in 2004—being the only scenario with a slight possibility of producing growth and poverty reduction sufficient to achieve MDG—is being pursued. It is, of course, essential that this scenario is in line with a prudent and sustainable debt strategy. While various donors have indicated preparedness to help finance the ambitious scenario of the PRSP, it is also important that grant financing is not crowded out by loans—however concessional these might be.

Even after the debt relief under the enhanced HIPC Initiative the debt-to-exports ratio of Benin remains high. Moreover, the deterioration of the net foreign assets (NFA) of the banking system over 2003 is of concern, particularly since achieving an adequate level of foreign exchange reserves is one of the targets of Benin's monetary authorities. As mentioned in the staff report, the reduction in NFA reflects especially the delays in cotton exports, and here the issue of the necessary diversification of the economy comes in the forefront again. We agree with the staff that Benin's strong dependence on cotton exports represents a major source of vulnerability. Sustainability of economic growth requires an improved business environment to attract investment not only in traditional sectors, but also in new areas with untapped potential. In this respect, we would appreciate the staff's comments on efforts

in this regard. Moreover, strong efforts to improve governance and fight corruption are key elements in any strategy for improving the business environment and achieving pro-poor growth. We welcome steps taken in that regard and look forward to see the results of the first governance and anticorruption survey to be completed before the end of 2003.

Ms. Boucher made the following statement:

We thank the staff for a concise and well-written report, and Mr. Ondo Mañe for his helpful and comprehensive preliminary statement. Our assessment of Benin's overall performance under the PRGF-supported program remains relatively unchanged since the last review earlier this year. The country continues to experience solid growth, increase its revenue performance, and maintains low inflation rates. It stands out as one of the best performing and complying members of the WAEMU under the Regional Convergence Growth and Stability Pact.

Following the fiscal slippages during the first quarter of 2003, the authorities confirmed their commitment to the program's objectives by rapidly implementing strong corrective measures. Despite these commendable results, it remains clear that the authorities need to continue their efforts to achieve sustainable growth and poverty reduction. Indeed, the Country Assistance Strategy for Benin discussed in July by the World Bank's board noted that, despite continued progress in macroeconomic stabilization and solid growth over the past few years, poverty remains widespread and inequality may have increased. Like Mr. Martí and Mr. Siman, we believe that accelerating the structural reform program is critical to achieving better results and reaching the Millennium Development Goals. Since I broadly agree with the staff's conclusions and recommendations, I will limit my comments to a few points.

First, we welcome the actions taken to improve tax revenues by strengthening customs administration, in particular. The resulting revenue to GDP ratio, at 16.9 percent in 2002, is expected to stabilize for the next three years; this achievement is particularly commendable and sets a strong benchmark for other countries in the region. Progress on fiscal consolidation and prioritization of public expenditure remain key elements for achieving the objectives of the PRSP. The World Bank and IMF's collaboration to provide support and technical assistance to the authorities to further strengthen public expenditure management is helpful in this regard.

Regarding the authorities' willingness to implement a more ambitious budget in 2004, we reiterate our concerns on improving the absorptive capacity, and the financial resources needed to fund new investments and to operate and properly maintain new infrastructure. Close coordination with the Fund, the World Bank, and other donors is also important, particularly to assess the viability and potential impact of these infrastructure projects.

Structural reforms remain the weakest point of the authorities' poverty reduction strategy and represent a major bottleneck to private sector development and growth. For instance, the introduction of private management for the Port of Cotonou could boost Benin's comparative advantage in the region and attract additional traffic. The privatization of SONAPRA is also an important element of the modernization of the cotton sector, and we hope this privatization will materialize as scheduled before the end of 2003.

Regarding civil service reform, it is crucial that the authorities rapidly address this important issue. We look forward to the new civil service reform strategy and expect its implementation will progress quickly. Reform in this area would help increase efficiency in the public administration and would also contribute to the authorities' efforts to control the wage bill. Following the upward trend in the wage bill experienced last year, a comprehensive analysis of the wage bill and all related expenditures is needed to ensure that objectives set for the coming years can be met.

To conclude, Benin continues to stand out as one of the most successful examples of progress as is among the few low-income countries in the world which have experienced real growth averaging above 5 percent over the past five years. But it also faces the challenge of sustaining its macroeconomic consolidation and accelerating its reform efforts to progress more rapidly toward the Millennium Development Goals. The World Bank and Fund assistance remains critical to support these efforts, particularly in the areas of competitiveness, diversification, how to address exogenous shocks, and in analyzing the link between growth and poverty reduction. Benin is also an interesting case in our ongoing reflections on the instruments that would best support the authorities' own efforts going forward.

With these comments, we support the conclusion of the fifth review of the PRFG-supported program and the granting of the related waivers. We wish the authorities continued success in their endeavors.

Mr. Maherzi made the following statement:

We thank the staff for a well-focused report and Mr. Ondo Mañe for his helpful statement. Economic performance in Benin in the first half of 2003 has been broadly satisfactory. Growth continues to be strong, and inflation remained under control, owing much to the authorities' adherence to the regional monetary policy of the BCEAO. The authorities are to be commended for their prompt response to the weakening of the fiscal performance during the first quarter of 2003. Following the nonobservance of two end-March performance criteria, the strong corrective measures adopted by the authorities during the second quarter have brought their program back on track and will help them meet their fiscal objectives for 2003. The

authorities are encouraged to maintain this stance, and we are reassured that they are, as reported by Mr. Ondo Mañe, committed to avoiding policy slippages, as these would threaten the important progress in macroeconomic stability achieved thus far. They deserve to be commended for meeting all other performance criteria and structural benchmarks for end-March, as well as the indicative targets for end-June. Benin's compliance with WAEMU's regional Convergence Stability, Growth, and Solidarity Pact is praiseworthy.

Progress has also been achieved in other structural areas. The privatization of the public ginning company is advancing, with World Bank assistance and the recruitment of an investment bank, and preparation for further decisive steps is underway. Most of the commercial banks are now complying with the prudential ratios of the Regional Banking Commission, which reflects the authorities' efforts in strengthening the financial health of the banking sector. In this regard, we look forward to the upcoming divestiture of the state-owned Continental Bank, which should enhance effectiveness of financial intermediation. It is also encouraging to note the authorities' efforts in strengthening governance, including steps taken to implement their national strategy to fight corruption. Like Mr. Andersen and Ms. Zubkova, we look forward to the results of the first governance and anticorruption survey.

Despite these remarkable achievements, much remains to be done to ensure sustained strong growth and significant poverty reduction, in line with the objectives of Benin's PRSP. Key challenges include maintaining macroeconomic stability and widening and deepening structural reforms, while promoting economic diversification.

Fiscal discipline remains central to preserving macroeconomic stability. We are encouraged by the authorities' commitment in this regard, and look forward to sustained implementation of the envisaged measures, as outlined in Mr. Ondo Mañe statement, to rationalize expenditure and enhance revenue mobilization. The authorities' objective of attaining fiscal targets, while ensuring increased social spending, is noteworthy. However, they should not rely too heavily on spending cuts, particularly when they affect infrastructure outlays, since, as Mr. Usman notes, "infrastructure projects could have a salutary impact on growth, poverty reduction, and private sector development in the medium to longer term." This underlines the need for continuous efforts to increase revenues, and the measures included in the authorities' action plan in this regard are in the right direction. Enhanced efforts are also needed to further improve effectiveness of public expenditure and increase absorptive capacity, with appropriate technical assistance while exploring, as called for by Mr. Usman, "the feasibility of channeling some grants and concessional loans into financing some of the large projects that have the most positive impact on the economy."

The heavy reliance on a single commodity continues to pose major risks to growth, poverty reduction, and debt sustainability prospects. Decisive actions are needed to encourage greater private sector involvement. Identifying and promoting alternative sources of growth and aggressively addressing impediments to private sector participation, including through reforming the legal and regulatory framework, streamlining and simplifying administrative procedures, and improving infrastructure would be instrumental to this end.

We are encouraged by Mr. Ondo Mañe's indication that the authorities remain committed to accelerating structural reforms, improving capacity building, and creating an enabling environment for private sector development. In particular, we are reassured that the rehabilitation and privatization process of the state-owned companies, including the ginning company, the telecommunications company, and the electricity branch of the public utilities company, is, in Mr. Ondo Mañe's words, "moving on as scheduled." The authorities are encouraged to push ahead with the liberalization of the cotton sector.

After reaching the completion point under the enhanced HIPC Initiative, Benin is now faced with the challenge of maintaining debt sustainability. The authorities are to be commended for steps taken to this end, in particular, by establishing a national debt committee to, inter alia, design and monitor overall debt policy. We support their call for further external assistance in form of grants and concessional loans. The authorities' success in enhancing growth, reducing poverty, and maintaining debt sustainability will hinge crucially on early and substantial reduction in cotton subsidies in major industrial countries.

In view of the authorities' achievements and strong commitment to macroeconomic stability and structural reforms, we support the proposed decision, and wish the authorities success in their endeavors.

Mr. Cho made the following statement:

At the outset, we concur with the thrust of the staff paper and support the completion of the fifth review. We also support the proposed decision on the waiver of two end-March quantitative performance criteria, given that the breaches were already cured and the program went back on track.

We commend the authorities for their strong ownership that brought this result and share the staff's assessment that this year's fiscal target is achievable. Priority spending has continued to be slow due to the weakness in the implementation capacity but we hope that it will improve as the devolution process gains pace in close consultation with both the Fund and the Bank.

Like other Directors, we welcome the progress in the divesture of public enterprises. We are also pleased to learn that a report is under preparation on cross claims and debts between public enterprises and government. It will certainly facilitate the clearance of arrears, not to mention preventing new ones. We also find the progress in the governance area encouraging.

I would like to finish with three specific questions.

First, on the large infrastructural projects, I note this issue was discussed at length at the previous review, in the light of still high level of external debt even with debt relief under the enhanced HIPC Initiative. Although the prospect for debt sustainability has improved somewhat thanks to an increase in cotton prices, continued caution seems to be appropriate. In this respect, I welcome the authorities' willingness to cautiously assess the feasibility of these projects and their financial implication in close collaboration with the Fund and Bank staff. I am sure that there will be an extensive search for grant and highly concessional loans in this process but I wonder whether the feasibility study will also consider the private sector participation in the projects.

Second, I regret that the authorities are not able to push ahead with the civil service reform-related legislation, although they have already implemented merit-based compensation system to new recruitment. Under this circumstance, the authorities indicated that they will develop a new strategy by the end of this year. Will this strategy consist in measures that do not require the revision of laws? Or will it be an attenuated version to appease legislators? The staff's comments would be appreciated.

Finally, this may be a somewhat premature question but I have to note that Benin has already benefited from three successive Fund arrangements as well as the completion point under the enhanced HIPC Initiative. Given the recent Board discussion on the Fund's policy on low-income countries, I wonder how Benin should be treated after the current arrangement that is scheduled to expire next March. I would appreciate if the staff could give some preview about their thinking.

With these remarks, I wish the authorities every success.

Mr. Skurzewski made the following statement:

We share the staff's assessment of Benin's performance under the PRGF-supported program. While economic growth and inflation were in line with the assumptions during the first half of this year, slippages occurred in the fiscal area. However, since the authorities have taken strong actions to address the missed performance criteria, we support the staff's

recommendation to grant the waivers for the missed performance criteria and complete the fifth review of the PRGF-supported program.

Benin's GDP growth is likely to continue its positive trend due to robust activity in the construction and services sectors, partly compensating for the subdued production in the cotton sector. However, there is significant vulnerability stemming from possible disruptions of trade due to the fragile situation on the border with Nigeria. Also, the situation in the Ivory Coast remains unstable and may have adverse effects on Benin's economy. These factors could negatively affect the already large current account deficit which, combined with a significant fiscal deficit, could put upward pressure on the country's debt stock and curtail investment. These issues reinforce the staff's case for suggesting Benin pursue diversification and facilitate private businesses in various sectors.

In the fiscal area, Benin's performance in the first quarter of this year was weak. Part of the fiscal slippage was due to increased spending on the elections. These overruns were massive despite the fact that the budgets for the municipal and legislative elections were larger than the previous election's budgets. Moreover, the procedure of planning the budgets for the recent elections was not transparent and was carried outside the new expenditure management system. However, the authorities have taken action by strengthening tax and customs administration to meet the annual program targets. Since the PRGF-supported program started three years ago, the overall progress in improving the fiscal position has been disappointing. This year, the primary balance deficit projected is higher than in any of the last three years. Compared with the average performance under PRGF-supported programs, Benin's fiscal adjustment has not been very ambitious.

Regarding the expenditure side, in the first half of 2003 priority spending in social sectors continued to lag. Perhaps due to this weak performance, the authorities decided not to implement the more ambitious alternative PRSP scenario. As a consequence, there is a substantial risk that there will not be sufficient capacity to execute the higher amounts of priority allocations for 2004 and beyond, and several donors may need to support the budget to help the implementation of the poverty reduction strategy. Therefore, we strongly support the staff's conclusion that the budget for 2004, which reflects the more ambitious scenario of the PRSP with higher expenditures in the priority sectors, should be adopted only after concessional external financing, consistent with the objective of debt sustainability, has been secured and only after the absorptive capacity for social spending has been improved.

The debt sustainability analysis shows that prudent debt management is necessary, even after HIPC assistance. The net present value of debt to exports ratio is projected to reach roughly 160 percent at the end of this year,

even after debt relief. We agree with Mr. Andersen and Ms. Zubkova's preliminary statement that the authorities should be prudent in acquiring new debt obligations. The establishment of a national debt committee is a welcome step in this context.

Finally, on structural reforms, the divestiture of public utilities and state-owned banks, as well as the privatization of SONAPRA in the cotton sector, should bring valuable efficiency gains. We welcome Mr. Ondo Mañe's information about the progress in the divestiture program and expect the authorities to take decisive steps in this area next year. In addition, we encourage the conclusion of the framework agreement between the Interprofessional Cotton Association and the government, which was negotiated in 2000 and defines the limits of intervention from both parties. The implementation of this agreement could be helpful for the SONAPRA privatization process.

We regret that civil service reform is still stalling, and hope that the envisaged civil service strategy reform will yield the desired effects. Since the president's position has been supported by the legislative elections in March 2003 and the cabinet reshuffle, the authorities are well advised to use the existing window of opportunity to rapidly implement these reforms.

The decentralization process has been very slow. While the first elections at the municipal level took place nine months ago, a follow-up action plan for the transfer of the management of budget appropriations are expected to be finalized only by the end of September 2003. Although the 2003 budget is insufficient to address the needs of the newly-created communities, this budget foresees financial transfers to the local authorities. However, for the time being, only very few communities have benefited from resource transfers from the central budget while a large number of communities have not received any funds for the execution of their duties. We strongly encourage the authorities to address these issues.

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

Mr. Cho asked what would be the next steps after Benin completes the current PRGF-supported program. As Benin is a prolonged user of Fund resources, an ex post assessment will be made in accordance with the guidelines of the Board, and we will consider the different options in close consultation with the authorities and with the various donors. We will also consult with the authorities to determine whether an enhanced surveillance program will be adequate or whether a low-access PRGF arrangement would be more desirable.

There were several queries by Mr. Usman, Mr. Jayatissa and Mr. Bhaskar, and Mr. Cho regarding the feasibility, prioritization, and financing of the large infrastructural projects. The staffs from the IMF and the World Bank are ready to assist the authorities in assessing the economic and the financial impact and the fiscal implications of these infrastructure projects. The authorities intend to conduct a feasibility study and, as stated in the Memorandum of Economic and Financial Policies, they will share the terms of reference of this study with the IMF and the World Bank. Currently, some of the large infrastructure projects are mentioned but not prioritized in the PRSP. In addition, as we mentioned in the JSA last March, these projects have not been assessed for their contribution to growth or poverty reduction.

The authorities have indicated that they intend to carry out the infrastructure projects mostly using BOOT contracts with the private sector, and that there is no budgetary allocation for these projects in the 2004 budget. The PRSP provides a prioritization strategy for all the other public sector expenditures. A tracking mechanism has been established that reflects the prioritization of the budget allocations for poverty-reducing expenditures. As Table 12 in the staff report indicates, the budgetary allocations include outlays for the education and health sectors as well as for critical infrastructure projects in areas such as agriculture and the access of clean water.

Several Directors, including Mr. Andersen and Ms. Zubkova, Mr. Martí and Mr. Siman, and Mr. Usman, asked about the policies being considered to accelerate growth, reduce poverty, and diversify the economy. The PRSP has developed a three-pronged approach to the growth objective which targets macroeconomic stability, improving the efficiency and the volume of pro-poor public expenditures, and implementing the structural reform program. The approach of the PRSP has been well summarized in some of the preliminary statements, especially in Mr. Jayatissa and Mr. Bhaskar's statement.

The structural reform agenda includes a divestiture program as well as a series of other measures to promote private sector growth, such as reform of the judicial and the legal systems. The staff are following the implementation of these measures closely in the context of the existing program. There are more specific sectoral measures that are contemplated in the PRSP for the sectors of agro-industry, tourism, information technology, and transit activity. We expect the authorities to review these measures in their progress report for the PRSP and in their annual assessment of the Poverty Reduction Strategy, which will also present the opportunity for the staff and other donors to exchange views with the authorities on these measures.

Regarding the development of value-added products in the cotton sector, there have been some initiatives by the government. However, most of these initiatives have been in a regional context where the different

governments have been reflecting on how to exploit the opportunities for more value-added products in the cotton sector in a more competitive environment. We will also follow that issue closely with the authorities.

There was a query on the implication of terminating the close surveillance of the Continental Bank in one of the preliminary statements. The recovery plan for this bank, which was a structural benchmark for end-2002, is progressing well. In particular, the prudential indicators, including the critical capital adequacy ratio, of the Continental Bank have improved. The Regional Banking Commission had taken sanctions against this bank because of the weaknesses that had been identified in the financial and the managerial aspects. The fact that the sanctions have been removed is a good indication that the weaknesses are being addressed in the context of the recovery plan. We expect the removal of the sanctions to facilitate the privatization process of the bank.

Mr. Abel made the following statement:

Benin's authorities are to be commended for the progress made with the program during 2002, and the actions they took in the second quarter of 2003 to correct the mixed performance of the first half of the year. Their strong progress with important elements of the PRGF reflects a major effort to complete the comprehensive poverty reduction program. We agree with the staff that these achievements, and the actions taken to correct the slippages in early 2003, justify Benin's continued access to Fund assistance.

But the successes with stabilization, growth, and strategic programs are marred by the lack of real progress with poverty reduction, a deficiency all the more astonishing given the massive international support mobilized by the World Bank and the Fund, whose advice Benin has diligently followed for nearly a decade.

Before the international community provides enhanced anti-poverty assistance, the authorities must be required, rather than just urged, to begin actually reducing poverty. A request for increased "outlays" for health and education must depend closely on strict control of non-priority outlays.

Technical assistance could help promote structural reforms such as privatization, but only if the priorities are clearly established. Assistance with privatization should not tell governments what to do and when to do it, but instead should focus on the "how to" aspects. Merely applying basic "best practices" to financial reforms, privatizations, and other structural issues can lead to lasting results. If these kinds of activities are not guided by proper incentives, it will not be easy to influence them from outside. After so many failures with short-cut approaches, it is time get serious about longer term consequences.

A recent study published by the International Food Policy Research Institute in Washington on the "Impact of Global Cotton Markets on Rural Poverty in Benin" **(http://www.cgiar.org/ifpri/divs/mssd/dp.htm)** indicates the existence of a strong link between cotton prices and rural welfare. A 40 percent reduction in farm level prices--roughly equal to the change in world cotton prices between January 2001 and May 2002—is likely to add 334,000 individuals to the number of persons living below the poverty line. This makes the authorities efforts to reform the cotton sector more important than ever. The progress already made is commendable, but still falls short of what is needed.

The reform of the cotton sector must succeed. To make it fully effective, it should be complemented by a reduction of subsidies to cotton producers in other countries, to relieve the pressure on pries of overproduction. Benin itself must diversify its exports to reduce the vulnerability of its economy to changes in the price of cotton.

Mr. John made the following statement:

We commend the authorities on Benin's continued strong performance under the PRGF-supported program, and welcome in particular corrective actions to address fiscal slippages early in 2003. We support completion of the review and will focus our comments on areas important to continued economic reform and poverty reduction.

Fiscal Policy

Weaker fiscal performance in the first quarter of 2003 that resulted from poor customs administration and overspending is disappointing given Benin's good track record. We applaud, however, the authorities' immediate response to address the fiscal slippages with both customs measures and cuts in non-priority spending in order to meet June targets. Going forward, we urge continued spending restraint and full implementation of measures to strengthen customs and tax administration, as well as non-tax collections from public enterprises, in order to meet fiscal targets. We note the important role Fund technical assistance played in design of customs and tax reforms.

On spending targets for health and education, we are concerned that continued shortfalls in these areas could compromise the fight against poverty in Benin. While Benin has shown an improvement since 2002 on execution of health and education budgets, Table 12 still shows that by end-June, only 23 percent of the annual budget allocation for expanding basic health services had been spent. Since more needs to be done to ensure that available funds are used to reduce poverty, we would have welcomed additional consideration of how absorptive capacity could be improved and look forward to further discussion in the context of the first PRSP progress report.

We are pleased to see that, since the last review, the authorities have adopted a single-reference database to help monitor government expenditures. The overrun of election expenditures, however, proved a disappointing test for the payment system, and we encourage the authorities to make proper adjustments for the system to work as intended. In addition, improving local spending controls will be important to ensure that fiscal devolution does not undermine gains in expenditure management at the national level.

Structural Reform

While the staff indicates that the government's stronger position following elections will help on structural measures, we are disappointed that to date there has not been more progress on civil service reform. The hiring of contract employees under a merit-based system as a temporary measure is a step in the right direction, but a long-term approach to foster a more efficient civil service is needed, and we urge additional efforts.

Progress with the privatization of the ginning company, SONAPRA, and the other parastatals should proceed on the agreed timeline, and we encourage continued cooperation with the World Bank in this area.

Debt Sustainability

We commend the authorities on their creation of a debt monitoring committee to help oversee debt policy and assess debt sustainability. Now that Benin has reached its completion point, it is crucial that the authorities carefully manage the composition of their debt stock and prevent debt build-up. Demonstrating strong economic performance will help boost donor confidence and maximize the grant assistance needed to support increased poverty-related spending in 2004 without adding to Benin's debt burden.

Additional Issues

We commend the authorities on their commitment to combat terrorist financing and money-laundering, and urge them to continue on this path. Strong implementation of the July 2002 anti-corruption strategy by the authorities is again encouraged, as good governance is one of the keys to meeting PRSP objectives and improving the business climate.

Given Benin's heavy dependence on cotton exports as mentioned by the staff and a number of Directors, we would have liked to have seen more discussion regarding diversification, which would reduce vulnerability to swings in cotton prices. At the last review we noted that Benin had done little to take advantage of AGOA trade preferences that could support growth of downstream processing, for example, and do not see progress yet.

We welcome the authorities' commitment to publish the staff report. On data, however, we note the significant weaknesses identified by the staff, question how these shortcomings do not affect the conduct of surveillance, and ask that the authorities step up their efforts in this area.

After adjourning at 3:48 p.m., the meeting reconvened at 5:25 p.m.

Mr. Santos made the following statement:

We thank the staff for a good report. The report seeks completion of the program review predicated on measures taken during the second quarter that were successful in bringing the program back on track. Because of that, and more importantly the generally good policy performance displayed by Benin over the years, we support the proposed decision. However, implementation of prior actions and other remedial measures should not be seen as a substitute for good program implementation. Indeed, rather than a stop and go approach to policy performance, sustained good performance is called for so that the challenges faced by the economy of Benin can be successfully addressed.

That said, we trust compliance with the program will remain over the second half of the year, even more so as the program does not seem overly ambitious during that period. In particular, given the sizeable gain in terms of trade, mostly reflecting a pick up in cotton prices in the world market, we believe the program could have targeted a more ambitious increase in the contribution of Benin to the reserves of the regional central bank.

It is true that the nominal appreciation of the currency and the decline of export volumes partially offset the effect of better terms of trade. However, after the sharp drawdown of reserves in 2002, also reflecting unfavorable cotton price developments, we would have expected that an equally large build-up in reserves would have been targeted this year.

The basic point we want to make, which was also touched on the paper on "Fund Assistance for Countries Facing Exogenous Shocks" discussed two weeks ago, is that countries should take advantage of favorable exogenous events to build up a reserve caution to allow them to weather the bad times. Otherwise, when those bad times arrive, they have to rely on borrowing, including augmentation of existing Fund arrangements, which only aggravates the indebtedness of economies with an already heavy debt burden. And this is especially true in economies like that of Benin, so dependent on a single commodity and consequently so vulnerable to fluctuations in its world market price. And the fact that as a member of the monetary union Benin has its reserves pooled at the regional central bank does not change the picture substantially.

In this specific case, we understand that the sharp increase in world cotton prices underpinning the improvement in terms of trade, reflects mostly expectations of a decline in supply in the United States determined by poor weather, rather than any increase in demand. Therefore, since supply should in time go up to normal levels, then if a stronger demand does not pick up the slack, which is uncertain at this point due to the global economic slowdown, there is a risk that the price hike is only a temporary event. The risk that prices could eventually go down and the fact that the currency arrangement in place does not provide the economy of Benin with an important buffer to address such exogenous events, only reinforce our conviction that a stronger increase in the contribution to the reserve pool of the regional central bank would have been preferable.

In terms of policy requirements, given the monetary arrangement in place, a more ambitious build up of reserves would have called for a tightening in the fiscal stance. Here, we also think there was some room of maneuver as the program accommodates sizeable increases in both the primary and overall fiscal deficits.

Finally, on structural reforms we agree with the thrust of the staff's recommendations. In view of the recent appreciation of the Euro, any competitiveness gains that allow a lasting narrowing of the external imbalance will have to be achieved through a strengthening in productivity, and for that to happen reform policies are crucial. In particular, given the hike in world cotton prices the timing is now right to finalize the reform agenda in the cotton sector. But more than contributing to improve productivity growth, reforms could also be instrumental in helping to diversify the economy away from the cotton sector, and hence reduce its extreme vulnerability.

Mr. Naka made the following statement:

Benin's economic and financial performance under the PRGF-supported program during the current review period has been close to satisfactory, and the authorities' commitment to the implementation of structural and other reforms is commendable. Despite those efforts, however, we find it quite disappointing that two performance criteria for end- March were not met.

I agree with the thrust of the staff appraisal, share the views of Mr. Andersen and Ms. Zubkova, and Mr. Cho, and support the proposed decision. However, I fervently hope that I will be able to support Benin's completion of the next and final review under this PRGF-supported program without expressing any regret or hesitancy regarding Benin's performance. With these remarks, I wish the authorities every success.

Mr. Wong made the following statement:

We would like to thank the staff for an excellent paper, providing a balanced assessment of recent developments in Benin and outlining the challenges facing the authorities. We also thank Mr. Ondo Mañe for his helpful and comprehensive preliminary statement. We broadly agree with the staff appraisal.

On the macroeconomic front, growth has been strong with inflation well contained. The authorities' steer of macroeconomic policies was generally skilful, except for the first quarter of this year, in which fiscal performance weakened. As a result, two performance criteria for end-March were not met. The importance of strong implementation of fiscal measures cannot be overstated, especially at this juncture in Benin, in maintaining macroeconomic stability—given that the external position remains vulnerable to shocks—as well as in supporting the momentum of structural reforms. It is thus encouraging that the authorities have since taken corrective measures to bring the program back on track. Indeed, the five measures in relation to the prior actions were met. Therefore, we do not have a problem in supporting the waiver. The only concern we now have is whether there exists a mechanism in Benin to ensure adequate social spending on education, health, infrastructure, and so forth.

On structural reforms, we commend the authorities for the considerable progress made in recent years. Their efforts in improving fiscal administration and control are particularly commendable. We thank the staff for the concise record of Benin's achievements in Box 3 and for the summary of the work in progress in Table 17 of the staff report. We support continuing to keep the structural conditionalities as streamlined as possible. We agree with the staff that implementation of the structural reform agenda is of critical importance for achieving the objectives of the PRSP. We support their call for close adherence to the timetable for divestiture of the state-owned bank, public utilities, and SONAPRA, as well as the elaboration of a new civil service reform strategy.

On poverty reduction, the authorities should be commended for stepping up efforts to address the shortcomings of the PRSP identified in the JSA. It is indeed timely to conduct the national household survey on living conditions, and the poverty and social impact analysis of the past and future cotton sector development strategy. We also welcome the efforts to deepen the private sector development strategy and to strengthen the monitoring and evaluation mechanism for the PRSP implementation. We look forward to the progress report and annual assessment.

Overall, we concur with the staff that risks to the medium-term program remain, but they are manageable. It is imperative that the authorities

implement strong macroeconomic policies to achieve macroeconomic stability and contain the risks. Given the current size of the savings-investment gap, a repeat of the fiscal slippage that occurred earlier in the year could endanger macroeconomic stability and retard reform progress. In addition, the pace of structural reforms must be quickened. The favorable external outlook, as reflected in the forecast recovery of cotton prices, appears to present a golden opportunity for taking bolder steps. Only through successful structural reforms can Benin effectively address its vulnerability—stemming mainly from a narrow economic base—and poverty issues in the long term.

With these remarks, we support the completion of the fifth review and wish the authorities success in meeting future challenges.

Mr. Maciá made the following statement:

The country's macroeconomic performance has been promising and sustained growth is envisaged for the medium term. Inflation has decreased and should remain subdued. Terms of trade have affected the external current account deficit, though better prices are expected for cotton exports in the near future. During 2002, authorities showed strong resolve with the program, meeting all quantitative performance criteria for end-September and all indicative targets for end-December. Fiscal performance was in line with the program objectives in 2002. In 2003, however, it did not meet the program's target due to weaknesses in customs administration and excesses in public expenditures. The authorities reacted with corrective measures, but priority spending in the health and education sectors continued to lag. The structural benchmarks for end-March, and indicative targets for end-June were met, setting the program back on track.

Structural measures advanced in various fronts. In the area of expenditure management, the authorities adopted an action plan to make the computerized expenditure management system (SIGFIP) fully effective. This should lead to more transparency while enhancing the tracking of poverty-reduction outlays. External debt services were integrated to the SIGFIP system, and externally financed projects will also be integrated next year. Initial steps were taken towards the privatization of the telecommunications and electrical sectors, which are due in 2004. On the banking sector, the government is preparing to divest the government's stake in the Continental Bank, and to rehabilitate the country's largest microfinance institution, FECECAM. The government aims at reinforcing the role of the private sector in the marketing of cotton seed; in this regard, the privatization of SONAPRA, is to be completed at end-2003 and the Port of Cotonou is to have its private operator in the course of next year.

The authorities remain strong in their commitment to reach the program objectives for this year. With the measures being taken to improve

customs administration, for instance, it is envisaged that the country will meet its budget target for 2003. The strengthening of public expenditure management (while safeguarding priority spending) is crucial to achieve the overall fiscal deficit levels pursued in the program. In addition, improving the government's capacity to implement poverty-reduction measures are a centerpiece to the PRSP's objectives. We welcome the initiative that aims at allowing budget appropriations to be managed by local governments and we trust that efforts will be continued to strengthen accountability and expenditure control systems at the local level.

We are pleased to know that the diagnosis for poverty reduction has improved and that the authorities are advancing with the poverty impact analysis (PSIA) targeting the future cotton sector reforms. We welcome the strengthening of the PRSP monitoring system, and look forward to the first assessment report on the PRSP implementation this September and the annual report in March of 2004. We praise the results of the 2000 HIPC Initiative audit which notes that programs are reaching the expected beneficiaries. We are eager to see the evaluation of the 2001 audit as well.

With these comments, we support the staff's recommendations to complete the program's fifth review and grant the requested waivers on the missed performance criteria. We praise the authorities for their perseverance and wish them success in their future endeavors.

Mr. O'Loghlin made the following statement:

This chair supports granting the waivers sought for the performance criteria which were missed last March under Benin's PRGF-supported program. We note in this context that all of the relevant structural benchmarks were met. We also note that strong policy action was taken by the authorities to respond, in particular, to the revenue shortfalls which caused the fiscal criterion to be missed – sufficient to bring the overall budget back on track so that the end-June performance criteria were all met. In consequence, we support the completion of this fifth review under Benin's PRGF arrangement.

At one level, economic performance has been quite satisfactory. Activity appears to be continuing strong, following annual growth in the 5 to 6 percent range for several years. Inflation is modest. And the fiscal position is at least tolerable, in the sense that deficits have not been driving up the debt/GDP ratio.

But at another level, developments have been less encouraging. It is worth noting that, with population growth close to 3 percent per annum, an annual 5 to 6 percent economic expansion is insufficient to allow any noticeable catch-up of per capita income with less-underdeveloped countries. However the pace of private investment—on which sustainable catch-up

depends—at little more than 10 percent of GDP in recent times is not demonstrating an adequate vibrancy. If I may borrow an expression familiar to my Chinese colleagues, it seems to me far too low to underpin "a great leap forward" for the average citizen amongst Benin's fast-growing population opposite. At that level, it does not give confidence that Benin is on a secure path of sustained, strong growth in per capita income and living standards.

As a consequence, I strongly agree with the staff that economic diversification, through private sector initiative and investment, is of critical importance. A few rhetorical questions may not go amiss.

First, do the authorities believe—I do not—that a private investment ratio far below that encountered in the generality of other countries can drive Benin's living standards forward at anything like a satisfactory pace?

If not, what are the reasons why willingness to invest in Benin's future is a good deal lower than desirable?

Could it be a narrowness of investment opportunities, or uncompetitive costs of essential—often publicly-provided—business services, which progress on privatization would unlock?

Or unease with inefficiency (or worse) in the wider public sector, which progress on civil service and governance reform would diminish?

Or are there widespread perceptions that rent-seeking, or effort directed to otherwise exploit the public purse, are more rewarding than effort devoted, instead, to driving businesses forward?

I strongly urge Benin's authorities to persist with, and carry through to completion in accord with the timetables now in place, their plans for structural reform. Prospects for sustainable investment, the key to growth in income and living standards going forward, will be heavily determined by the extent of success in implementing such reforms.

With these thoughts, I wish the authorities and people of Benin success and greater prosperity into the future.

Mr. Williams made the following statement:

I agree with Mr. Andersen and Ms. Zubkova's preliminary statement and would particularly like to associate myself with the five points listed in their statement, which reflect many of the key issues. There are several additional issues I would also like to draw the Directors' attention to.

It is worth noting that Benin is a star pupil in the Franc Zone and we should acknowledge that accomplishment. It has made progress in other areas in recent years, as Mr. Ondo Mañe stated in his preliminary statement. However, the key challenge facing Benin is to meet the levels of growth and poverty reduction which underpin its PRSP strategy. To meet this challenge, Benin needs to move forward on three issues. The first issue is the structural agenda, which as other Directors have noted, the authorities have basically not tackled. The second issue to address is meeting the need for increased and sustainable levels of concessional financing. The third issue to focus on is finding ways to mitigate the many risks that Benin faces as a single commodity economy.

On the structural agenda, as other Directors have said, the authorities must make quick progress on privatization and public sector reform; Ms. Boucher highlighted the key issues there. Regarding aid, there are two issues which are not currently relevant but would be helpful to address in the next review. First, the staff's assessment on the likelihood of Benin securing the levels of concessional financing that are assumed in the high case debt sustainability scenario would be useful; and second, if these levels of financing do not materialize and cotton prices do not remain at their current level, which given the recent history is probably highly unlikely, a discussion of Benin's options to meet its target levels of public expenditure and poverty-reducing would be constructive. On these issues, I would like to make a quick reference to the HIPC Initiative completion point discussion on forecasts and topping up.

In addition, the country's budget integrity is clearly at risk, as highlighted in 2003. As Mr. John stated, the authorities should be cautious about further devolution of the budgetary resources and authority to the 77 municipal councils without ensuring that the appropriate safeguards are in place. There are clearly fiduciary risks in the devolution process.

Finally, like other Directors, I would like to make the case for a future program. Benin faces a large reform agenda going forward, much of which lies in the Fund's core areas of expertise. I urge the staff and management to react positively to any request for a further PRGF arrangement from the authorities. Benin clearly needs support going forward, and I hope that we can react positively to that need. In conclusion, I support the proposed decision.

Mr. Ondo Mañe made the following concluding statement:

I would like to thank the staff for their dedicated work on Benin and for their comprehensive answers to the questions raised by Directors. I would also like to assure Directors that I will faithfully convey their suggestions and remarks to my authorities. Also, I would like to thank Directors for their comments and advice on Benin, and express the gratitude of my authorities

for the conclusion of the fifth review of the PRGF-supported program. Since the staff representative eloquently answered Directors' questions, I will be brief in my concluding remarks.

My Beninese authorities have continued to make significant progress in the areas of macroeconomic policy and structural reforms. Output growth is robust while economic and financial performance is improving and inflation remains subdued. On the political side, the ruling government has won the legislative elections and national and international observers have confirmed that the elections were true and fair. I can also assure Directors that the authorities view public service management, including tax and customs administration, as important sectors to improve upon. My authorities are well aware of the fact that macroeconomic stability is essential for poverty reduction objectives. For that reason, my authorities are committed to rationalizing and improving the management of the fiscal sector.

I have noted the key recommendations of Directors, including the comments made by Mr. Zoccali and Mr. Usman on fiscal slippages and the remarks by Mr. Usman, Mr. Zoccali, and Mr. Martí on enhancing poverty reduction. The staff representative's comments on the three aspects of the PRSP strategy in Benin should also assure Directors of Benin's commitment to poverty reduction.

On the large infrastructural projects, I would like to confirm the staff representative's statement that my authorities will take into account the macroeconomic viability of these infrastructure projects and will consider the advice from donors and other agencies. On privatization, I would like to confirm, as stated in my preliminary statement, that my authorities are committed to the privatization of SONAPRA, the Port of Cotonou, and the telecommunications company.

Since Benin has achieved the completion point under the Enhanced HIPC Initiative in March 2003, the authorities have taken measures to monitor debt sustainability. For that reason, they have also established a national debt committee.

Finally, Directors have recognized Benin's high dependence on cotton and the need to diversify the economy. My authorities would like to continue to count on the international community's support to achieve this objective.

The Acting Chair made the following summing up:

Executive Directors commended the authorities for the progress achieved under the PRGF arrangement, noting that, in the first half of 2003, economic activity remained buoyant and inflation subdued. They welcomed the authorities' adoption of strong fiscal corrections in the second quarter to

put the program back on track, after a weakening of fiscal performance earlier in 2003, and that all indicative targets for end-June and structural benchmarks for end-March were observed. On this basis, they concluded the fifth review under Benin's PRGF arrangement.

Directors endorsed the authorities' commitment to undertake further fiscal consolidation, to strengthen poverty-related spending, and to redouble efforts to implement structural reforms. They stressed that the achievement of the fiscal targets would require the successful implementation of measures to improve the performance of the tax and customs administrations, as well as continued efforts to rein in nonpriority outlays, while avoiding excessive cutbacks in critical infrastructure. They supported the authorities' intention to settle cross claims and debts between the central government and public enterprises.

Directors emphasized the importance of increasing poverty-reducing expenditures and strengthening the absorptive capacity of these expenditures to achieve PRSP objectives. In their view, a critical component of this process is to improve the expenditure management system to enhance transparency and the tracking of poverty-related outlays. They agreed that devolution of fiscal responsibilities to the local governments would be beneficial in improving the efficiency of health and education expenditure, but would also require strengthening of local government budget management capacity.

Directors noted that the authorities are seeking additional external assistance in 2004 to finance the more ambitious budgetary scenario of the PRSP and recommended that the authorities secure grant or highly concessional financing, consistent with debt sustainability. To strengthen the management of debt, they endorsed the establishment of a national debt committee.

Directors also emphasized the importance of timely and transparent implementation of the structural reform agenda to achieve PRSP objectives. In particular, they urged the authorities to strictly adhere to the timetable for the privatization of the state-owned ginning company (SONAPRA) and the public utilities. They also urged the authorities to rapidly develop a new civil service reform strategy with an appropriate, merit-based wage policy.

Directors expressed concern about the economy's high dependence on cotton exports and encouraged the authorities' efforts to diversify the economy, and promote small and medium size enterprises. They also welcomed initiatives to improve governance and fight terrorist financing, money laundering, and corruption, noting, in particular, the survey on corruption to be completed by end-2003.

Directors acknowledged the efforts of the authorities to address the shortcomings of the PRSP, mainly related to the lack of clear mechanisms and indicators for monitoring outcomes. They were encouraged that the first progress report on the PRSP implementation would be completed by end-September 2003, and the first annual assessment of the PRSP by end-March 2004.

Directors concurred that the regional monetary policy of the BCEAO continues to serve Benin well. To strengthen the soundness of the financial sector, they looked forward to the authorities' continued resolve to improve bank compliance with the Regional Banking Commission's prudential ratios, with special attention given to lending practices and loan portfolio supervision. In this regard, they endorsed the authorities' plans to rehabilitate the state-controlled bank and to divest the government's stake in this bank. They noted the growing significance of microfinance credits and welcomed the authorities' continued support for the rehabilitation of microfinance institutions and commitment to intensify the supervision of this sector.

Directors welcomed Benin's continued commitment to comply with the regional convergence criteria and common trade policy of the West African Economic and Monetary Union (WAEMU). They underscored the need for the Fund to support WAEMU member countries in their efforts at regional integration.

The Executive Board took the following decision:

1. The Republic of Benin has consulted with the Fund in accordance with paragraph 2(dddd) of the three-year arrangement for the Republic of Benin under the Poverty Reduction and Growth Facility (PRGF) (EBS/02/119, 7/1/02) and paragraph 4 of the letter dated January 29, 2003 from the Minister of Finance and Economy of the Republic of Benin in order to review program implementation.

2. The letter dated August 25, 2003 from the Minister of Finance and Economy of the Republic of Benin, together with its Memorandum of Economic and Financial Policies (the "Memorandum"), and the Technical Memorandum of Understanding (the "Technical Memorandum"), shall be attached to the three-year PRGF arrangement for the Republic of Benin, and the letters dated July 10, 2000, December 26, 2000, October 5, 2001, July 26, 2002, and January 29, 2003 from the Minister of Finance and Economy of the Republic of Benin, together with their respective attachments, shall be read as supplemented and modified by the letter dated August 25, 2003 from the Minister of Finance and Economy of the Republic of Benin, together with its Memorandum and Technical Memorandum.

3. The Fund decides that the fifth review contemplated in paragraph 2(dddd) of the three-year PRGF arrangement for the Republic of Benin is completed and that the Republic of Benin may request disbursement of the sixth loan referred to in paragraph 1(cccc)(ii) of the arrangement notwithstanding the nonobservance of the end-March 2003 quantitative performance criteria specified in paragraph 2(aaaa)(i) and 2(aaaa)(ii), respectively, of the arrangement, on the condition that the information provided by the Republic of Benin on the performance under these criteria and on the implementation of the measures specified as prior actions in paragraph 7 and Table 1 of the Memorandum is accurate. (EBS/03/126, 8/27/03)

Decision No. 13097–(03/86), adopted
September 10, 2003

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/03/85 (9/5/03) and EBM/03/86 (9/10/03).

5. RULES AND REGULATIONS AMENDED SINCE 2002 ANNUAL MEETING

The Executive Board approves the letter to the Chairman of the Board of Governors submitting for review by the Governors the texts of the amendments to the Rules and Regulations adopted since the 2002 Annual Meeting and the proposed resolution for the Board of Governors, as set forth in EBD/03/82 (9/4/03).

Adopted September 9, 2003

6. APPROVAL OF MINUTES

Minutes of Executive Board Meetings 03/49, 03/50, 03/51, 03/52, and 03/54 approved.

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by Assistants to Executive Directors as set forth in EBAM/03/119 (9/4/03) and EBAM/03/120 (9/5/03) is approved.

APPROVAL: December 18, 2003

SHAILENDRA J. ANJARIA
Secretary