December 24, 2002
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/100

10:00 a.m., September 23, 2002

Contents

Executive Board Attendance

A. Krueger, Acting Chair
E. Aninat, Acting Chair
S. Sugisaki, Acting Chair

Executive Directors	**Alternate Executive Directors**
	A.S. Azzaz
	N. Guetat, Temporary
	K. Kpetigo, Temporary
	T.-M. Kudiwu, Temporary
I.E. Bennett	C.J. Faircloth, Temporary
M.J. Callaghan	D.C. Guinigundo
	T. Moser, Temporary
K. Bischofberger	R. von Kleist
P.C. Padoan	F. Manno, Temporary
	D. Lombardi, Temporary
	L. Rizzotti, Temporary
D.I. Djojosubroto	Low K.M.
	P. Lathouly, Temporary
Y.V. Reddy	R.A. Jayatissa
W. Kiekens	J. Prader
	I. Ábel, Temporary
	J. Jonáš, Temporary
Ó. Ísleifsson	B. Andersen
	M.L. Nikitin, Temporary
	M. Lundsager
	J.W. Ralyea III, Temporary
	S. Boitreaud
	S. Boucher, Temporary
A. Mirakhor	S. Rouai, Temporary
A.V. Mozhin	A. Lushin
	I. Zakharchenkov, Temporary
	F. Varela
	M. Beauregard, Temporary
	P. Moreno, Temporary
T. Scholar	M.A. Brooke
	B. Kelmanson, Temporary
	J. Gallardo, Temporary
	A.A. Tombini, Temporary
C.D.R. Rustomjee	I. Usman
A.S. Shaalan	M.B. Chatah
	N.H. Farhan, Temporary
Wei Benhua	
J. de Beaufort Wijnholds	Y.G. Yakusha
	T. Komatsuzaki, Temporary
A.G. Zoccali	G.R. Le Fort
	L. Ocampos Temporary

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary, A. Mountford, Acting Secretary
Z.R. Ahmed, Assistant; H. Mooney, Assistant; J. Puig, Assistant, M. Schulte, Assistant

Also Present

IBRD: I. Diwan, M. Pigato, African Regional Office; A. Damais, M. Waxman, Financial Market Integrity Department; M. Giugale, S. Webb, Latin America and Caribbean Regional Office; B. Marchais, MIGA Legal Department. African Department: J. Fajgenbaum, Deputy Director; D. Guillaume, G. Kalinga, M. Nowak, T. Strauss, A. Tahari, J. Wiegand, A. Yamauchi. Asia and Pacific Department: P. Berezin, C. Duenwald. European I Department: M. Takeda. European II Department: E. Gelbard. External Relations Department: L. Mboto Fouda, S. Nardin, R. Nord, K. Roesser. Fiscal Affairs Department: E. Jenkner. Independent Evaluation Office: M.S. Ahluwalia, Director; D.J. Goldsbrough, Deputy Director; I. Mateos y Lago. International Capital Markets Department: P. Breuer, L. Papi. Legal Department: W.E. Holder, Deputy General Counsel; J. Jones, N. Kyriakos-Saad, C. Ogada, P.M. Sengupta, B. Steinki, J. Thony. Monetary and Exchange Affairs Department: S. Ingves, Director; V Sundararajan, Deputy Director; J. Abbott, T. Balino, I. Carrington, M. Cortes, T. Donovan, R. Gordon, D. Hardy, B. Johnston, M. Moore, A. Ouanes, K. Sasaki, M. Tamagawa, M. Vasquez, M. Zephirin. Policy Development and Review Department: M. Allen, Deputy Director; S. Dodzin, P. Gajdeczka, A. Gilmour, K. Hviding, A. Kapteyn, R. Kincaid, A. Mourmouras. Secretary's Department: M. Da Costa, L. Hubloue, P. Ramlogan. Treasurer's Department: M.G. Kuhn, Deputy Treasurer. Western Hemisphere Department: A. Singh, Director; M.E. Bonangelino, Deputy Director; C. Collyns, E. Faal, A.M. Jul, E. Kalter, R. Krieger, J. Marquez-Ruarte, J. Toro, P. Young. Office of the Managing Director: A.A.E. Bertuch-Samuels, Special Advisor; A. Mazarei, S. Tiwari, A. Tweedie. Office of Budget and Planning: C. Vehorn., H. Young. Office of Technical Assistance Management: C. Liuksila, Director. Advisors to Executive Directors: S.A. Bakhache, A. Baukol, M.P. Bhatta, J.A. Costa, B. Couillault, P.R. Fenton, F. Haupt, K. Kanagasabapathy, S. Kropas, S. Le Gal, D. Lewis-Bynoe, H. Litman, Liu F., M.F. Melhem, J. Milton, T. Miyoshi, P.A. Nijsse, E. Nyambal, L. Palei, Y. Patel, C.E. Pereyra, A. Requin, K. Sakr, F. Vermaeten. Assistants to Executive Directors: M. Abbing, A. Alber, S. Alcaide, V. Bhaskar, V. de los Santos, M. Di Maio, H. Fabig, R. Gauba, E. González-Sánchez, B. Gulbrandsen, C. Gust, C. Harzer, H.-H. Jang, N. Joicey, J.T. Kanu, A. Lanza, Y. Lissovolik, A. Maciá, R. Maino, R. Manivat, T. May, K.S. Oo, A. Rambarran, B. Siegenthaler, T. Skurzewski, A. Stuart, E.A. Thambwe-Mwamba, N. Watanabe, Wei X., Yu J.

1. ETHIOPIA—2002 ARTICLE IV CONSULTATION; POVERTY REDUCTION AND GROWTH FACILITY—REVIEW; AND POVERTY REDUCTION STRATEGY PAPER AND JOINT STAFF ASSESSMENT

Documents: Staff Report for the 2002 Article IV Consultation and Third Review Under the Poverty Reduction and Growth Facility Arrangement (SEBS/02/158, 8/21/02; and Sup. 1, 9/18/02); Poverty Reduction Strategy Paper (EBS/02/130, 8/28/02); Poverty Reduction Strategy Paper—Joint Staff Assessment (EBD/02/131, 8/28/02; and Cor. 1, 9/17/02); and Statistical Appendix (SM/02/281, 8/29/02)

Staff: Tahari, AFR; Kincaid, PDR

Length: 2 hours, 5 minutes

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

> Additional information has become available since the issuance of the staff report for the 2002 Article IV consultation and third review under the Poverty Reduction and Growth Facility Arrangement (EBS/02/158). The information does not change the thrust of the staff appraisal.
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> As indicated in the letter of intent of August 19, 2002 and in Table 3 presented in Appendix I of the staff report for the 2002 Article IV consultation and third review under the Poverty Reduction and Growth Facility Arrangement, the first two prior actions were completed before the report was issued to the Executive Board on August 21, 2002. The third prior action was completed as scheduled on August 31, 2002. The prior actions included (i) the adoption by the Council of Ministers of a budget for fiscal year 2002–03 consistent with the revised fiscal framework presented in the letter of intent; (ii) international tendering of the financial audit of the CBE; and (iii) the revision of the recently adopted regulation for the provisioning by banks for nonperforming loans and other doubtful assets to bring it more in line with international best practice, by including five categories for the classification of nonperforming loans, and removing any temporary weakening of provisioning that may result from the phasing in of the new requirements.

Mr. Rustomjee submitted the following statement:

> Introduction
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> My Ethiopian authorities express their profound gratitude to the staff for their continued invaluable advice and assistance in implementing the current Fund-supported PRGF program. A serious commitment to implementing wide ranging reforms and pursuing prudent macroeconomic

policies, in a steady and sequenced fashion, have been the hallmark of the authorities' efforts for the last few years. The commitment has been reinforced by the steady progress toward peace with Eritrea, which has contributed to the reduction in military expenditures and the associate increase in poverty related outlays.

Ethiopia's progress in implementing the current program continues to be strong. In this regard the authorities have observed all the quantitative and performance criteria under the program, as well all the benchmarks, with only one small deviation. The minor deviation relates to the regulation of provisioning requirements, which was not implemented fully in line with international best practice as was required under the program. My authorities have made the commitment to correct this shortcoming.

Macroeconomic Developments under the Program

Growth performance over the last few years has been strong as a result of the implementation of wide ranging reforms, sound policies and foreign assistance. GDP growth performance during 2000–01 was estimated at 7.7 percent, but receded to 5 percent, as a result of lower commodity prices, particularly coffee and cereals. My authorities are confident that Ethiopia is able to sustain a GDP growth potential of approximately around 6 percent over the medium- to longer term. This level is needed to address the prevailing poverty, and to raise Ethiopia's very low income per capita. The higher growth performance over the last few years has already resulted in an increase in the country's per capita income, but my authorities are cognizant of the fact that these efforts would need to be sustained in order to break the cycle of poverty, and allow the country to make progress towards the Millennium Development Goals. The authorities have also taken various steps to increase rural incomes including measures to encourage crop diversification, ensure farmers' production decisions are market driven through better price transmissions, and to enhance rural transport. These efforts illustrate the authorities' commitment to create an enabling environment to increase the productive capacity of the rural population, which is needed for enhanced GDP growth performance, and also to exit from poverty.

Ethiopia adopted an expansionary fiscal policy stance over the last two years, by frontloading poverty related expenditures. As a result of this policy, higher fiscal deficits were recorded and a budgeted deficit 9.7 percent is estimated for 2002–03. The projected deficit is however still in line with the objectives of the program, but is expected to decline to 4.7 percent in 2004-05.

While revenue collections were slightly lower than programmed during the review period, my authorities continued to implement measures to strengthen the institutional basis for increased revenues. As a result of tax measures implemented over the last few years, the level of income as a percent of GDP increased by 3.7 percent to 16.2 percent in 2001–02. These measures included the strengthening of the large tax unit and the institution of a tax reform task force. After widespread consultation and thorough preparation, my authorities also enacted the Value Added Tax Act in July 2002, which will become operational in January 2003. All of the efforts have been undertaken to ensure that the tax base is broadened and revenue collections enhanced to promote sustainable fiscal policy over the long-term.

As regards expenditures, steadfast expenditure controls continue to be cornerstone of my authorities in executing expenditure policy. Tight budgetary management has ensured that the fiscal objectives of the program remained in line, and expenditures during the period under review were lower than programmed. Continued progress has also been made in lowering military outlays and in increasing poverty related current and capital expenditure.

Since the last review, considerable progress has also been made in tracking and reporting on public expenditures, consistent with the recommendations of many Directors. These efforts are comprehensively highlighted in Box 4 of the staff report and include improved budgetary formulation to integrate extra-budgetary expenditures and revenues, the continuing decentralization of expenditures to district level, the strengthening of the budget preparation process, the introduction of an integrated computerized financial information management system, and the monitoring of expenditure expenditures in the priority sectors, particularly related to poverty spending.

My authorities are also committed to decentralized public expenditure to ensure that the poverty-related expenditures reach the intended target groups. In this regard they have embarked on a strategy to further decentralize expenditures to the district level, while at the same time they have taken steps to improving capacity at all levels of government. My authorities are also cognizant of staff's recommendation that further efforts to decentralize public expenditures should follow enhanced reporting and monitoring of local government expenditures.

The Ethiopian authorities continued to implement monetary policy with the objective to maintaining a low inflation rate. Negative inflation rates were recorded over the last two years as a result of depressed food prices due to the importation of food aid. Core inflation of approximately 3 percent is projected 2002–03, and the authorities are committed to use the available monetary policy instruments to ensure that the inflation rate stays within the program targets.

As regards exchange rate policies, my authorities have made considerable progress in liberalizing the foreign exchange market. In this regard restrictions on the purchase of foreign exchange for holiday travel and education purposes have been eliminated and an interbank foreign exchange market instituted to replace the wholesale foreign exchange auction. Notwithstanding the implementation of these measures, the birr remained fairly stable during the period under review, and the estimated level of net foreign assets at US$319 million is also higher than the programmed target.

As regards financial sector competitiveness, the authorities are in the process of implementing reforms which are intended to improve the soundness and competitiveness of the financial sector, albeit in a gradual fashion. Considerable efforts are being made to ensure the prudent management of the National Bank of Ethiopia (NBE), and in this regard, the authorities commissioned a study concerning the operational, organizational and administrative setup of the National Bank of Ethiopia (NBE). Furthermore, the Audit Services Corporation has submitted an unqualified audit of NBE's financial statements, to the NBE's board, as was recommended by the safeguards assessment of the NBE. Subsequently, steps have been taken to ensure that the NBE's accounting records properly reflect the balances held in the foreign correspondent banks.

In addition to considering measures to ensure the prudent management of the NBE, the authorities continue to pursue efforts to ensure that the Commercial Bank of Ethiopia (CBE) is run on a commercially sound basis. After the setback suffered with the withdrawal of a foreign bank from the contract to manage the CBE, my authorities appointed in March 2002 a new management team to manage the CBE on a commercial basis.

As regards the operation of foreign banks in the Ethiopia the authorities reiterated that they have in principle no objection to such a process. They have stressed however that the financial sector should first be further strengthened, since various uncertainties still exist regarding the impact that foreign banks would have on domestic interest rates, the exchange rate, as well as the authorities concern as to the possible dominance of the banking sector. The authorities nevertheless remain in favor of a sequenced and gradual approach to enhance competition in the financial sector, including foreign participation.

Ethiopia's external current account deficit increased to 6.6 percent of GDP in 2001–02 from 4.2 percent in 2000–01. It is expected to increase only marginally during the forthcoming year. My authorities are committed to further trade liberalization, and in this regard plan to reduce the average import tariff from the existing level of 19½ percent to 17½ percent, the maximum tariff from 40 percent to 35 percent and the number of bands from 7 to 5, in January 2003. A study on effective protection as well as on the progressive elimination of tax and duty exemptions, which is intended to guide Ethiopia's future trade reform efforts, is also underway.

Social Policies and the PRSP Process

My authorities have made substantial progress in consulting with broad civil society and with the donor community on a strategy to alleviate poverty, and in this regard have completed and forwarded the full PRSP to the joint staffs of the IMF and the World Bank for assessment. My authorities recognize that the PRSP remains a living document that will be updated by the time of the first annual PRSP progress report. The PRSP report focuses appropriately on rural development. My authorities are pleased that the joint staffs of the IMF and the World Bank consider their poverty reduction strategy as appropriate and providing a sound basis for World Bank and Fund concessional assistance.

Conclusion

My authorities remain committed to fully and comprehensively completing the current program, and are determined to use the resources which may be released, following the successful completion of the review, for poverty related expenditures.

My authorities have demonstrated consistently and over a number of years, their firm commitment to adjustment and reform and intend to maintain the same commitment over the entire medium-term and beyond. The international community's support to these efforts is critical to enable my authorities to meet their program objectives as well as long-term growth and poverty alleviation objectives. Support for the proposed decision to complete the third review today, would represent an important contribution in this regard.

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

We thank the staff for the well-written report and Mr. Rustomjee for the helpful statement. Since the restoration of peace between Ethiopia and Eritrea, the authorities are making good progress in the implementation of sound macroeconomic policies and structural reforms in a number of areas with the primary focus on regenerating faster growth and poverty reduction. Given that Ethiopia is one of the poorest countries in the world, substantial reduction of poverty in the immediate future remains a major challenge. We commend the authorities for their commitment and efforts, demonstrated by their satisfactory performance under the program. It is encouraging that, with continued implementation of sound policies and progress in the peace process, the medium-term prospects looks good and we support the completion of this review under the program.

On the fiscal policy, we are of the view that the revision to fiscal target to accommodate higher than originally planned social spending and other considerations, mentioned by the staff appears appropriate. However, careful management of expenditure is essential to ensure fiscal discipline; particularly we emphasize the need to ensure that expenditure would not go out of alignment with resource availability. We welcome the progress being made on public expenditure management as mentioned in Box. 4. While we realize the capacity and other constraints, it may be helpful to gradually start making progress in some of the reforms identified as key-long term reforms in that box, such as the inclusion of donor activities in the budgets which would also help to improve transparency and accountability of donor support. We also share the staff's emphasis on the importance of improving the effectiveness, reporting and monitoring of local government expenditure before further decentralizing public spending. On the revenue side, it is encouraging that the authorities have accelerated the pace of implementation of tax reforms including in their preparations to introduce VAT early next year. However, the cautionary foot note in page 16 indicates some problems in implementation. An update on whether this has been resolved would be helpful.

We welcome progress being made in the implementation of reforms to strengthen the financial sector and improving its competitiveness. While we note the authorities' concern regarding foreign participation in the financial sector, we encourage them to reconsider their decision not to allow such entry. We note the authorities' plans for trade reforms. We encourage them to make early progress in simplifying and rationalization of the tariff structure. While we note the significant progress has been made in removing exchange restrictions, we encourage the authorities to eliminate the remaining restrictions and accept Article VIII status early.

We welcome the progress made in the finalization of the full PRSP and stress the importance of continued implementation of structural reforms focusing on civil service reform, public expenditure management and private sector development as suggested by the staff.

Mr. Portugal and Mr. de los Santos submitted the following statement:

Ethiopia's performance under the PRGF-supported program during 2001–2002 has been satisfactory. It is encouraging to note that all quantitative and structural performance criteria and benchmarks to December 2001 and March 2001 were observed. We congratulate the authorities for these results and for their firm commitment to the arrangement. We agree with the staff that to achieve the program's economic and social objectives—mainly a sustained and robust real GDP growth and a significant reduction of poverty—they should continue implementing sound economic policies and structural reforms, while closely monitoring the program.

Economic management brought mixed results. Real GDP growth was strong and inflation negative and official reserves almost doubled to 3.9 months of import coverage. However, the external current account deficit, though lower-than-programmed, rose by 2.4 percentage points to 6.6 percent of GDP, due to a combination of dismal export performance, higher-than-projected imports, and lower private transfers.

During 2001–02, the overall fiscal deficit increased by 4.2 percentage points of GDP to 9.9 percent, as a result of higher-than-programmed expenditures. Although we take note of the staff's indication that a significant share of these expenditures constituted social spending, we understand that a further relaxation of the fiscal stance could create undue pressures, putting at risk efforts to reduce actual fiscal imbalances and to accomplish medium-term fiscal consolidation. The authorities should focus on rationalizing expenditures and limiting current outlays to necessary items, while prioritizing programs and projects identified as key in helping to reduce poverty. In this connection, we welcome Mr. Rustomjee's remarks on the set of measures taken by the authorities to improve productive capacity and incomes of the rural populations. While we note that for the first nine months of 2001-02 revenues were slightly lower than programmed, we commend the authorities for their encouraging progress in rising revenues along the last three fiscal years, owing to an important enhancement in tax collection. Nonetheless, we are of the view that there is room for further improvements and, in this regard, we encourage the authorities to persevere in their efforts to reach the program targets. We see as promising their intention to strengthen fiscal management, and welcome the adoption of several tax measures, including the reinforcement of the large taxpayer unit, and the plan to introduce a VAT next January.

Except for some delays in the timely implementation of some programmed measures, the structural reforms agenda has been broadly implemented as expected. We are confident that the authorities will continue committed to timely execute the set of pending measures intended to reform the civil service and to foster private sector development. We welcome the set of measures taken to strengthen the financial sector health and improve its competitiveness, such as the decision to adopt a revised regulatory framework for the provisioning of NPLs, and the actions intended to make the Commercial Bank of Ethiopia (CBE) more efficient by operating under a new management team and on a more profit-oriented basis. Regarding the latter, we agree with the staff's call to the authorities for continued actions on the effort to address CBE's most important problems, and on the need to perform an audit by a reputable firm.

We commend the authorities for their commitment to complete the PRSP within the expected timeframe, and recognize their efforts to assure a broadly participatory process by the civil society and the donor community. We see as appropriate the staff's warning that the medium-term macroeconomic framework adopted in the PRSP should be cautiously evaluated once additional external assistance is identified, in order to preserve macroeconomic stability and debt sustainability.

Finally, we support the proposed decision and wish the authorities well.

Mr. Wijnholds and Mr. Litman submitted the following statement:

We are aware that the scale of the development challenge in Ethiopia is almost unparalleled, with a population of over 65 million people and one of the world's lowest per capita incomes; and that the frequent droughts and limited agricultural productivity relative to population pressure have generated an overriding concern about food security.

It is regrettable that the great effort that was invested in deep and wide-ranging set of consultations undertaken by the government in preparing the PRSP, served mostly to provide reactions to the government' s existing policies and programs, rather than to craft new ones. As the commitment at the local level, which is critical for successful implementation of the plan, remains largely untested, we urge the government to find creative ways to further deepen the participatory process. This consultation process should find causes other than rapid population growth, why poverty has hardly declined over the last five years. Open and sincere discussion will find the economic, social, and institutional causes, and point to past policies which had a negative impact.

It is worrying that the government based the PRSP on an even more optimistic scenario than the PRGF: 7 percent annual real GDP growth rate compared with 6 percent under the PRGF-supported program, while GDP growth for 2001–02 is estimated to have decelerated to 5 percent. We wish to point to the clear signals predicting a serious deterioration in the economic situation of Ethiopia due to weather conditions (drought). In our opinion this has not been taken into account in the macro economic projections as presented in the staff document. It is likely that the next PRGF review indicates a far more pessimistic picture with regard to variables such as GDP, tax revenues, fiscal deficit, etc. More alternative scenarios should be developed.

While we welcome the reallocation of budgets from defense to education, health, agriculture, and rural infrastructure, we join the staff in urging the government to accelerate this process.

In the document and throughout the implementation of the PRGF-supported program since its inception, the staff has repeatedly indicated that the government should pursue vigorously its efforts aimed at strengthening the financial sector and enhancing its competitiveness. In fact, financial sector reform can be considered one of the essential elements of the PRGF. However, the staff has not made any reference to any consequences in case of continued non-compliance. We wonder why the staff continues to show so much flexibility in this respect. We strongly recommend that the government reconsider the existing policy of not allowing foreign banks entry. While understanding the government's concerns, we wish to point out that high concentration of deposits and loans in the Commercial Bank of Ethiopia, which is currently restructured, effects the banking sector's ability to provide much needed new credit. Foreign banks will bring more diversified lending and more efficient financial intermediation. The authorities might issue banking licenses only to reputable, highly rated foreign banks. The foreign banks' expansion could be controlled by limiting the assigned capital to the local branch, as, say, 1 or 2 percent of the bank's global capital. It is also possible to limit the foreign banks' ability to transfer local savings abroad by issuing a regulation, which would put a ceiling on the ratio between local deposits and local assets.

In footnote 14, the staff observes a delay in the process of introduction of the VAT and the TIN due to differences of views between the authorities and the contractors with regard to the computerization component of the projects. We wish to strongly support the staff in encouraging the authorities to resolve the differences and make further progress as the tax reform program is key to the realization of the PRGF and the PRSP.

On page 24 staff indicates the need for the government to accelerate the privatization program. We fully underline this need, at least for certain straightforward sectors such as the tourism sector as potential (foreign) investors have been discouraged by excessive prices.

We support the proposed decision.

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

Ethiopia should be commended for maintaining good economic performance under the PRGF, made possible by progress in the peace process with Eritrea. Given Ethiopia's satisfactory track record, we support the completion of the third review.

To achieve a prudent fiscal stance, it is necessary that the authorities limit increases in the wage bill and defense spending to allow higher spending for poverty reduction.

Monetary policy should maintain a prudent stance to keep inflation stable.

The empirical evidence suggests that foreign bank entry improves the functioning of the financial system. We therefore encourage the authorities to reconsider their decision on foreign bank entry.

We support the implementation of structural reforms, in consultation with the World Bank, aimed at improving public sector management and enhancing growth.

We are pleased that Ethiopia has maintained good economic performance under the PRGF-supported program, with robust GDP growth and a slightly smaller external current account deficit than programmed. Further progress in the peace process with Eritrea will afford the authorities a window of opportunity for achieving growth and implementing an agenda for poverty alleviation. We also note that Ethiopia observed all the quantitative performance criteria and benchmarks. Although all but one structural performance criteria and benchmarks were also met, they had implemented all prior actions. Given Ethiopia's satisfactory track record, we support the completion of the third review.

Nonetheless, the economy is still vulnerable to exogenous shocks as it depends largely on agricultural production. The decline in agricultural prices will be sufficient to wreak havoc on small producers in rural areas and thus, aggravate poverty. The key challenge therefore for Ethiopia is to broaden its economic base in order to reduce its vulnerability to commodity price shocks and adverse weather conditions. To this end, it is critical for the authorities to diversify production and prepare a conducive environment for prudent macroeconomic policies and wide-ranging structural reforms. These will all serve to alleviate poverty.

Fiscal Policy

While the fiscal deficit in 2001–2002 is estimated to increase by 0.8 percentage points compared to the program, we are reassured that the fiscal deficit is estimated to have been contained within the original target in absolute terms. In a situation where consumer demand is sluggish and poverty remains formidable, it is necessary for the authorities to sustain public expenditure in order to stimulate economic activity and develop rural areas. In this context, we welcome the understanding for higher spending in priority areas by appropriate revision of the original target in the 2002–2003 budget. However, to achieve a prudent fiscal stance, it is necessary for the authorities to limit the increases in the wage bill and defense spending to allow higher spending for poverty reduction.

We are encouraged by the authorities' action to reform public expenditure management in order to improve the allocation of resources and monitor poverty-related spending. However, we share staff view that public spending should be further decentralized in a cautious manner to ensure adherence of local government expenditures to national policy.

The authorities should be commended for implementing tax reform by strengthening the large taxpayer unit, improving tax administration, and introducing a VAT system. It is encouraging that over the last two years, the tax to GDP ratio rose by 3.7 percentage points to 16.2 percent in 2001–2002 by strengthening the tax measures as noted in footnote 4. It will be interesting to know from staff whether the authorities confronted any resistance from taxpayers as the tax ratio to GDP increased substantially compared to the previous year.

Monetary Policy and the Financial System

Monetary policy should be cautious to ensure price stability. The loose monetary policy through interest cuts in March should be revisited, as the rate cut is unlikely to have a significant impact on economic activity in a situation where economic activity is subdued and investor confidence is fragile. In this regard, we share staff's view that the authorities should keep interest rate policy under review and maintain positive real interest rates. On exchange rate policy, the authorities should be commended for liberalizing the foreign exchange market through eliminating certain restrictions and introducing a daily interbank market. The authorities' intention to pursue a flexible exchange rate policy is welcome.

We commend continued efforts to improve the competitiveness of the financial system through the lifting of restrictions on the payment of interest on current account deposits. Furthermore, it is noteworthy that the largest state-owned bank, the CBE, is under the oversight of an audit committee to improve financial performance. With regard to the entry of foreign banks, the authorities' concern is right that enhancing the supervisory capacity of the central bank is important to cope with increasing competitiveness pressures. Nevertheless, such pressures could have positive effects. The empirical evidence suggests that increased foreign bank entry improves the functioning of the financial system, enhances its efficiency by increasing competition, and supports economic growth. In this context, we encourage the authorities to reconsider their decision not to allow foreign bank entry.

PRSP and Other Issues

We commend the extensive work on the full PRSP based on broad consultation with civil society and development partners. While the PRSP presents a substantial development agenda, we note that there are several areas of weaknesses that should be addressed. We understand this will be revised and updated to address gaps in the strategy.

We support the implementation of various structural reforms, in consultation with the World Bank, particularly on improving public sector management. We encourage the authorities to accelerate the privatization program in industrial enterprises to ensure that the public sector is focused on its core activities.

Mr. Rustomjee reiterated his gratitude for the staff's excellent work and fruitful relationship with the Ethiopian authorities. Moreover, the authorities had agreed to the publication of the staff report. With respect to the insightful statements of Directors—particularly Mr. Wijnholds's—despite efforts to solicit responses to Directors' comments and questions from the authorities, the Ethiopian Minister's travel had made it difficult for him to respond.

Ms. Nikitin made the following statement:

I would like to start by commending the authorities for good macroeconomic performance under the PRGF-supported program. The performance has indeed been quite impressive taking into account adverse external developments, and especially the persistent decline in the coffee and cereals prices, which continues to put pressure on the economy. The authorities have fulfilled all performance criteria, benchmarks and prior actions, and thus I support the completion of the third review.

As Mr. Rustomjee points out in his statement, Ethiopia's performance during the last few years has been a result of the implementation of wide ranging reforms, sound policies, and foreign assistance, and I believe that the second annual PRGF-supported program provides a sound basis to sustain Ethiopia's good performance. While the program's emphasis on poverty alleviation is appropriate and the relaxation of the fiscal target is justified, I fully agree with staff that a significant reduction of the fiscal deficit starting from 2003 is critical for Ethiopia's macroeconomic stability. In this context, it is very important to make progress in public expenditure management, and I encourage the authorities to carry on with the reform program of the public expenditure management system.

Let me now turn to the PRSP, which in my view provides a good framework for Ethiopia's poverty reduction strategy. I appreciate the consultative process undertaken to develop the PRSP, and I hope that the spirit of participation generated with civil society representatives will be broadened and sustained during implementation and monitoring of the PRSP.

The PRSP covers a very ambitious reform agenda, including a wide range of interrelated sector policies and programs. However, given the very limited government capacity and resources, the PRSP would have benefited from clearer prioritization. The need for prioritization is even more evident when looking at the medium-term scenario underlying the poverty reduction strategy, which is more ambitious than in the PRGF-supported program. As the staff report points out, the Ethiopian economy is sensitive to adverse shocks, such as export prices. Taking into account, for example, coffee price developments, the medium-term scenario in the PRSP seems quite optimistic. It could be useful for the authorities to produce alternative medium-term scenarios in case the present one does not materialize and to think about contingency measures well in advance.

Of the various topics covered in the PRSP, I will just briefly comment on private sector development and trade policy. The private sector development strategy, which is laid out in section 8 of the PRSP, takes a comprehensive and coherent approach, and its emphasis on ongoing dialogue between the government and the private sector is welcome. However, the section lacks a clear analysis of bottlenecks to private sector development, and while a large number of policy intentions are described, there is no indication of priorities. I would encourage the authorities to prepare indicators for private sector development based on the policy intentions set out in the section 8.

Finally, as is recognized in the PRSP, export growth and the diversification of the export base are important for pro-poor growth and poverty reduction. In this regard, it could be useful to include a trade strategy explicitly in the PRSP. In our market access discussion last week, staff indicated that there is a need for technical assistance in this area and that they are trying to integrate trade issues into the PRSP process. I think that Ethiopia is a good example of a country, where we could put these ideas into practice.

Mr. Jonas made the following statement:

Ethiopia's performance under the program has so far been satisfactory. But the recent slowing of its GDP from nearly 8 percent to 5 percent shows that Ethiopia remains vulnerable to commodity price changes and other shocks affecting agriculture. As other speakers have noted, this once more confirms the need for Ethiopia to diversify the economy further. I also note that the fiscal deficit is estimated to have widened by 3 percent of GDP, which may have helped prevent an even sharper decline in output.

As other speakers have observed, Ethiopia's poverty remains enormous in spite of recent progress in increasing per capita GDP. Success in reducing poverty will require rapid sustained growth. A growth-friendly environment must be patiently cultivated to make rapid growth sustainable. I feel some concern about the authorities' tendency to mistake higher fiscal spending as a means of reducing poverty. The PRSP framework contains some optimistic assumptions and objectives, including higher growth, higher inflation, and higher fiscal deficits in the later years, than the PRGF framework. The authorities will make a serious mistake if they try to accelerate growth and poverty reduction by means which increase instability or deepen Ethiopia's indebtedness. It is important that the authorities stick to the PRGF baseline projections.

There has already been a very steep increase in social spending in response to the significant reduction of defense spending. In the period 2000-2005, it is projected that social spending will increase by 11.5 percent of GDP. Increased social spending is welcome: indeed, it is the ultimate goal of the PRGF. But it is equally important to ensure that the large increase in spending is effectively allocated.

Let me now turn to the financial sector, where improved functioning will play an important medium-term role in supporting growth. The authorities seem to agree with the staff banking sector reform is urgently needed. This should include measures to increase competition and reduce the Commercial Bank of Ethiopia’s dominant role in the sector. Like the staff and many other Directors, I think allowing the entry of foreign banks will be the best way of strengthening the financial sector. But the authorities seem to prefer a different sequence. They would strengthen their financial sector first, before allowing foreign participation.

Unfortunately such a strengthening will require more human and financial resources than Ethiopia now possesses. The authorities are also concerned about the exchange rate and interest rate effects of foreign participation in Ethiopia's financial sector. I am a bit puzzled, because I think they should worry more about the interest rate effects of the weakness of competition in the financial sector. Figure 1 (page 25 of the staff report) shows an increase in maximum lending rates at a time when inflation and deposit rates were falling, producing a significant widening of interest spreads. This suggests that Ethiopia's banking sector could benefit from some increase in competition, and even from a limited entry of foreign banks. The positive experience of other countries with the participation of foreign banks should not be dismissed too lightly.

With these comments, I support the proposed decision.

Mrs. Boucher made the following statement:

I would like to thank the staff for a well-written report and joint staff assessment on the PRSP, as well as Mr. Rustomjee for his very helpful statement. Like other Directors, I am encouraged by continued progress under the program, and the authorities’ progress toward restoring the peace between

Ethiopia and Eritrea. While GDP growth for 2001–02 was lower than expected, Ethiopia's performance remains broadly on track with all of the quantitative and structural performance criteria, and all but one of the benchmarks. The reallocation of defense spending to priority outlays means that poverty expenditures should surpass defense spending in 2001–02. The authorities are expected to accelerate the pace of reforms aimed at strengthening revenue collection, while progress is being made toward improving public expenditure management—these are all steps in the right direction. However, the challenges ahead remain enormous, particularly those that relate to setting Ethiopia upon a path toward strong and sustainable growth.

The Fund and World Bank have an important role to play in assisting the authorities in this process. In this regard, we appreciate the information provided on the discussions between authorities and staff, particularly on fiscal policy and the financial sector. Both parties are attempting to reconcile their views and to build a more solid partnership under the program, as noted by Mr. Rustomjee.

Regarding the PRSP, I would like to support the comments of Directors who called for further work on diversification through the development of sectoral strategies, and for a deeper consultative process through the institutionalization of civil society participation in policy design and implementation. Furthermore, the link between the budget and the PRSP processes should be strengthened through more precise technical and financial programming. Regarding the PRGF review, we join the staff in urging the authorities to remain cautious about expenditure policy, though some relaxation of the 2002–03 deficit target in order to accommodate increased spending in priority areas is acceptable. More ambitious targets for military spending cuts are also welcome. The implementation of measures to increase revenue will also be needed, particularly the introduction of the VAT by January 1, 2003.

On medium-term prospects, like Messrs. Wijnholds and Litman, and Ms. Nikitin and Mr. Jonas, we believe that the PRSP scenario for the outer years diverges from the projections under the program. We therefore encourage the authorities to adhere to a prudent fiscal plan in order to establish their medium-term scenario, which is critical to maintaining macroeconomic stability and debt sustainability.

Though we appreciate the authorities' motivation for ambitious targets, which reflect the expectations of civil society for the Millennium Development Goals, the Ethiopian economy remains highly vulnerable to exogenous shocks and external financing. Alternative scenarios and contingency plans would be a more appropriate way to support these objectives, while ensuring that potential shocks are adequately anticipated so as not to threaten the overall PRSP framework.

The implementation of the HIPC Initiative requires prudent debt management, thus the donor community—primarily the World Bank—must carefully design lending policies in order to avoid affecting long-term debt sustainability, and ensure that lending is commensurate with Ethiopia's absorptive capacity. We believe that additional information will become available on Ethiopia's progress toward meeting the completion point targets by the time of the next review. We encourage the authorities to conclude agreements with non-Paris Club creditors on comparable terms, and we would like a detailed account of the status of these negotiations at the time of the next review.

Regarding the financial sector, the current situation is not conducive to private sector led growth. Mr. Rustomjee noted that the authorities have no objections to the introduction of foreign participation in the financial sector. However, I share the views expressed by Mr. Jonas and other Directors, and join them in encouraging the authorities to press ahead in their efforts to strengthen the financial sector and to consider permitting foreign bank entry in order to enhance competition and efficiency. The audit of the CBE should also be completed as scheduled.

Last week's discussion with the World Bank highlighted the need to promote private sector involvement. Confidence must be instilled in foreign investors through the improvement of governance, the legal system, and trade reforms. In this regard, a rapid resolution to pending disputes with private investors would be a positive development. Furthermore, the PRSP review would benefit from the development of a system of indicators designed to help monitor progress in private sector development.

In conclusion, we agree that Ethiopia's performance has been satisfactory, and we support the proposed decision. Nevertheless, we encourage the authorities to maintain a prudent fiscal stance, with emphasis on reducing expenditure, prudent debt management, faster implementation of measures aimed at strengthening the financial sector, and improving the business climate. We wish the authorities success in their challenging endeavors.

Ms. Farhan made the following statement:

We would like to thank staff for a well-written set of reports that cover a number of complex issues pertaining to the Ethiopian economy. The boxes on public expenditure management and structural reforms are particularly useful.

It is a pleasure to be able to comment on Ethiopia at a time when it appears that both macroeconomic performance and the PRGF-supported program appear largely on track. The authorities' efforts to achieve fiscal consolidation and macroeconomic stability appear to be bearing fruit. Although a number of economic indicators in 2001–2002 have been weaker than anticipated, the near term outlook is much brighter. As always, however, there are some potential downside risks, which could develop into vulnerabilities that could affect the country's future prospects. We would like to take this opportunity to make some comments in this regard.

First, on fiscal policy, we note the authorities' efforts to improve fiscal management. Given Ethiopia's somewhat uneven past performance in this area, the more positive performance covered in this review is particularly welcome. However, we strongly encourage the authorities not to slip into complacency, as continued progress will require firm implementation of the proposed reforms. In this context, the proposed budget for 2002–2003 seems appropriate, particularly given additional spending needs explained in paragraph 25 and in Box 3. Moreover, its focus on macroeconomic stability through contained recourse to domestic borrowing is also most appropriate. We urge the authorities to fully implement the budget proposals.

Like other Directors, we are of the view that reform of public expenditure management is critical to meeting the fiscal objectives. The PEM will, as it has in so many other PRGF-supported cases, form the backbone of Ethiopia's PRSP. Steady implementation of both short- and medium-term measures outlined in Box 4 are consequently of critical importance. Improvements to budget formulation and execution will be particularly vital. In this context, perhaps staff could comment on the degree of technical assistance Ethiopia is receiving on the fiscal front, and whether the authorities might not benefit from a long-term advisor on the budget process. Further, while we join staff in welcoming the sizeable increase in social spending since the beginning of the PRGF-supported program in 2000, we would continue to urge careful prioritization of such spending to ensure maximum social impact.

On the revenue side, we concur with staff that firm implementation of tax reforms, including improvements to the large taxpayer unit and implementation of the VAT will be critical if Ethiopia is to continue to adjust along the proposed fiscal path. Given Ethiopia's high dependence on trade taxes—roughly 32 percent of non-grant revenue—these measures will be vital if the revenue trajectory is not to drop following envisaged reductions in external tariffs in early 2003. Our question to staff on this issue is to what extent have the authorities "planned for the worst"? The operation of new tax systems, such as the VAT, invariably comes with a few implementation difficulties, some of which have already become visible, and revenues frequently fall short of expectations. Have staff and the authorities identified contingency measures that could be taken to protect the proposed fiscal targets should the VAT and other measures fall short of the mark in the first few years? We encourage the authorities to closely monitor fiscal developments with a view to adopting new measures if the need arises.

On monetary and exchange rate policy, we concur with staff's view that the exchange rate regime is adequate. The floating rate has served Ethiopia reasonably well in absorbing shocks and ensuring competitiveness. Introduction of indirect policy instruments and further strengthening of the financial system should enhance performance in this area. We have some sympathy for the authorities' desire to give the domestic banking system some additional time to prepare for external competition, including through strengthened supervision. However, if the authorities wish to create a modern and efficient financial system, then opening the financial services sector to external competition - and the technology and know-how that comes with it - will be extremely useful over the medium term. We encourage the authorities to complete the audit of the Commercial Bank of Ethiopia and to prepare a plan for its restructuring, in order to reduce the bank's dominance and, as such, possibly increase competition in the banking sector. We encourage the authorities to consider a medium-term plan for both issues.

Finally, on structural reform, we note and welcome the efforts of the authorities supported by the World Bank to enhance the role of the private sector in the economy, and to implement civil service reforms. We would like to ask whether Ethiopia is being considered for assistance under the Integrated Framework, and whether a trade integration study might be in the works in the next few years.

With these comments, we can approve the proposed decision and wish the authorities every success.

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

Regarding the potential impact of tariff reforms, the authorities expect that these will be relatively neutral, as the tariff rates for commodities included in the restructuring and simplification process will vary.

Regarding questions on the issue of tax reforms, the problems that have been identified in the staff report regarding the tax identification number project have been resolved, and an agreement was reached between the contractor and the authorities; as a result, we do not see further problems in terms of the preparation for the VAT. Furthermore, the authorities expect VAT reforms to have a positive impact on the economy. They agreed that a 15 percent rate will replace the current rate scheme, consisting of various individual rates—i.e., 7, 10, and 15 percent. Administrative reforms—particularly the establishment of the large taxpayer unit—are also bearing fruit. The authorities also plan to introduce an equalization mechanism for taxpayers earning below 500,000 birr per year. The staff will monitor these reforms closely and will review the situation in mid-2003 to ensure that no tax collection problems arise. The fact that the authorities have put this much effort into this reform process is rather encouraging.

Regarding the public's attitude toward tax reform, the Ethiopian authorities have spent a great deal of time and effort explaining and consulting with the private sector—especially on the introduction of the VAT. In this regard, we have not noticed a great deal of resistance on the part of taxpayers.

Regarding public expenditure management, a great deal of technical assistance has been provided by the Fund, World Bank, and USAID. Several recent missions from our Fiscal Affairs Department have been completed, and another mission is set for October. At this time, we do not see the need for long-term technical assistance. However, the establishment of an AFRITAC in Tanzania will allow Ethiopia to benefit from technical assistance in the future. Ethiopia is also one of the countries participating in the Integrated Framework initiative—a mission was recently there, and a study is likely to be carried out on trade as part of the Integrated Framework initiative. We are monitoring this process along with our colleagues from the World Bank.

Regarding Ethiopia's prospects for economic growth, one issue of importance is the impact of the drought. The staff's projections from mid-June were undertaken when the authorities were still holding-out hope for rain during the summer. Unfortunately, the rains in July, August, and September fell short of expectations, and subsequently the agricultural output for 2002–03 will be lower than expected. Real GDP growth for next year may be lower than 6 percent, which was the figure projected at the time of the review. However, as the third annual program review will take place early next year, we will reassess the situation with the authorities then, and will inform the Board of developments.

Regarding financial sector reforms, we agree with the comments of several Directors on exchange and interest rates. The authorities were concerned about the experiences of neighboring countries when financial liberalization and competition were initially introduced. During a workshop on the role of the financial sector in economic development, the staff and other guest speakers from neighboring countries explained that Ethiopia's case would be completely different from that of neighboring countries—Box 2 of the staff report attempts to summarize some of these issues. Mr. Rustomjee indicated that in principle, the Prime Minister of Ethiopia stated that they were not against the introduction of foreign financial institutions. The staff will continue to encourage the adoption of such measures.

In the interim, the authorities have been concentrating on the restructuring of the CBE, and the staff report outlined the various measures that were agreed upon. A question from the statements asked about the possibility that some of these measures might not be implemented. The staff report noted that the next annual program should be discussed early next year, and the authorities are aware that we would not be able to initiate program discussions until an external audit was undertaken—this audit is planned to be completed by January, and will include the planned restructuring of the CBE.

Regarding Mr. von Kleist's suggestion that the staff should have included additional information in the statement issued on September 13, 2002, I would like to begin by apologizing to the Board. However, this additional information was not included in the statement because reliable data was not available then regarding the potential impact of the drought on real GDP growth, and the various other potential implications of this situation.

Mr. Zakharchenkov's asked about measures undertaken by the authorities to improve the soundness and competitiveness of the financial sector, as well as the issuance of government guarantees for assets held in Eritrea. The problem with the liabilities of the commercial banks is that, in the absence of government guarantees, these amounts would be listed on the books of the main commercial banks, which would affect their key ratios and ability to operate.

Ms. Rizzotti made the following statement:

First of all, let me thank the staff for their very interesting set of reports and Mr. Rustomjee for his comprehensive statement.

We commend the Ethiopian authorities for the results obtained over the last few years, for the satisfactory implementation of the PRGF-supported program and for the adoption of the full PRSP, in the context of a steady progress towards peace with Eritrea.

We broadly agree with the thrust of the staff appraisal, and we only have brief comments on some issues, including the macroeconomic outlook, fiscal policy, financial sector competitiveness, trade openness, and the PRSP.

With respect to the macroeconomic outlook, great care should be placed in avoiding discrepancies between the PRGF and the PRSP. We therefore welcome the indication that the PRGF-supported program will be kept as baseline scenario. Moreover, we share the staff assessment that, since this scenario already requires sound policies and favorable external conditions, the first PRSP progress report should include also a downside risk scenario.

Considering the exposure of the country to external shocks, such as deteriorating terms of trade or unfavorable weather conditions, we would also appreciate a few comments by the staff on a possible contingency plan.

In response to the recent drop in food prices, we welcome the authorities' talks with food aid donors finalized to increase the purchase of local food in order to avoid unnecessary downward pressures on food prices, as already agreed by the European Union.

On fiscal policy, we commend the authorities for the implementation of a number of tax measures and the results obtained in terms of higher revenues. We welcome the reduction in defense spending, and we expect this trend to continue. We also welcome the substantial increase in capital and poverty reduction related expenditures. However, given the size of the fiscal deficit, we invite authorities to strictly adhere to the PRGF targets, and to not rely on future, external support.

We also urge the authorities to consider carefully the implementation of further decentralization of public spending. The process will have to be monitored with emphasis placed on securing control capacity of local expenditures, since revenues will remain mostly at the central level (p. 16 par. 27).

We take note of several measures recently taken to improve the financial sector. However, we also note that the competitiveness of the sector remains weak, as suggested also by the high (and raising) interest rate spreads (see table 3: from 7 pp in 98-99 to 11 pp in 2001–02).

Needless to say stronger, more competitive and a more efficient financial sector is crucial to support investment and growth. This will be particularly relevant in the medium term, when public investments will decline from the high levels registered in years 2001-03 (see Table 3—12.5 percent in 2002–03 to 10.8 percent in 2004–05)

In this context, we agree with the staff recommendation of opening the sector to foreign investors with the appropriate timing. We also note that sequencing is important in order to avoid risks of vulnerability. Thus, priority should be given to strengthening supervision and regulation bodies (and monitor their implementation), and to restructuring key financial institutions, in particular, the Commercial Bank of Ethiopia.

The sequencing issue brings us to trade openness. We appreciate the initiatives undertaken to reduce tariffs. However, these efforts could be intensified in the future, together with the implementation of measures for infrastructure development and diversification of the export base.

Looking ahead the structural agenda is wide ranging, including a more comprehensive liberalization, stimulating savings and investment, and fighting poverty. We therefore welcome the actions the authorities are implementing in consultation with the World Bank, and the activity undertaken with MIGA assistance to settle the expropriation claims.

As long as the PRSP is concerned, we commend the authorities for the preparation of the report, for the comprehensive consultation method and the adequate country ownership. However, we agree with the staff conclusion on the need of better priorities specification, and timing of implementation measures.

Moreover we note that greater attention should be given in the document to the issue of export and trade development, especially taking into account the sensitivity of the balance of payments to adverse shocks.

In addition, we observe that the high costs and the lack of a sufficient transport infrastructure have been a binding constraint for the development of other sectors, for the external trade and also in terms of food security. Therefore, we appreciate the satisfactory implementation of the first phase of the Road Sector Development Program (RSDP) and we hope that the second phase included in the PRSP, aimed at connecting different regions of the country, will be addressed promptly.

With these comments we wish the authorities continued success in the future.

Mr. Ralyea made the following statement:

The Ethiopian authorities continue to meet the program requirements. This is due in no small part to the authorities' own efforts; however program flexibility has also played a role. While a certain amount of program flexibility may be necessary, great care must be taken to avoid jeopardizing medium-term sustainability. With that thought in mind, we support completion of this review.

Tension Exists Between Program Flexibility and Sustainability

The authorities certainly face a daunting task in raising living standards and reducing poverty in one of the world's poorest countries. We appreciate the authorities' commitment to undertaking most needed reforms. However, it is important to point out that there could be a trade-off between program flexibility and the achievement of long-run sustainable growth.

For example, under the revised program, net domestic financing of the government at the end of this fiscal year is projected to exceed the program projections in EBS/02/37 by over six percent. In isolation, such flexibility may not erode sustainability, but it complicates the implementation of monetary policy and could crowd out private sector investment. More worrisome, estimated external debt relative to GDP in July 2002 exceeded the programmed amount by more than ten percentage points of GDP, notwithstanding the authorities' solid efforts to improve tax revenue. The government's guaranteeing of assets held in Eritrea, which the Russian chair highlighted, only adds to our worry.

Reprioritize Expenditures Away from the Military

We agree strongly with Mr. Portugal and Mr. De los Santos that a further relaxation of the fiscal stance could put at risk efforts to accomplish medium-term fiscal consolidation. To the staff's credit, there are repeated warnings throughout the document that great care will have to be taken to ensure that future external assistance is spent efficiently on poverty-related sectors. We concur with Ms. Boucher that further reprioritization or reduction of defense spending seems warranted.

We note that after two years of rapid reducing defense expenditures, those expenditures are now projected to exceed the projections under the original program for the current fiscal year. In a country where an estimated five million people need external food assistance, despite an overall food surplus, this seems ill-advised. In the short run, this money would be better spent transferring food from food-surplus regions to food-deficit areas. Over the medium term, money slated for military expenditures could be used to improve or build irrigation networks and roads to lower the probability of future food crisis. In a nut shell, the failure to continue reducing military spending represents a real cost to Ethiopians in terms of human and physical capital development.

Strengthen Conditionality on CBE Reform

In addition, the program continues to treat reforms related to the Commercial Bank of Ethiopia as structural benchmarks. Given the importance of an overhaul of the ownership and operations of the CBE to the health of Ethiopia's financial system, it may be time to convert some of the structural benchmarks to performance criterion. Like Mr. Wijnholds and Mr. Litman, we interpret the light treatment of CBE reforms in the program's conditionality as another example of the program's flexibility that could unnecessarily delay the development of a robust economy. We also share Mr. Guinigundo's, Mr. Jang's and other Directors' belief that the authorities should reconsider their policy of not allowing foreign bank entry into Ethiopia's financial sector. Mr. Jonas made a good case for allowing foreign bank entry.

Other Structural Measures that Require Attention

We urge the authorities to ensure that sub-national governments have the capacity to handle increased revenue and expenditure responsibilities before decentralization proceeds much further.

Along with Mr. Reddy and Mr. Jayatissa, we encourage the authorities to make early progress in simplifying and rationalizing the tariff structure.

To build investor confidence, we agree with Ms. Boucher that the authorities should continue their efforts to resolve outstanding expropriation cases.

As we noted in the World Bank Board's discussion last week, we support the PRSP's emphasis on improving the agriculture sector and the environment for private sector growth. Going forward, it will be important to set priorities and make demonstrable progress.

Conclusion

Finally, we welcome the seriousness with which the authorities undertook and followed through on the recommendations of the safeguards assessment. The active pursuit of corrupt CBE officials is noteworthy. Such efforts, as well as the decision to publish the staff report, help to foster an environment of better governance and transparency.

Mr. Zocalli and Ms. Ocampos made the following statement:

First, let me thank the staff for the well-focused document on Ethiopia and Mr. Rustomjee for his insightful statement.

In recent years, Ethiopia has implemented a wide range of structural reforms and pursued a prudent management of macroeconomic policies in the midst of efforts to restore peace with Eritrea. We are glad to observe that the PRGF- supported program has been satisfactorily implemented, with the quantitative and structural performance criteria and benchmarks having been met, with the exception of one related with the financial sector. The outlook for 2001/2002, however, has deteriorated with a lower than-expected economic growth, deflation, and higher fiscal and current account deficits. On these assumptions staff´s projections pointing to a sustainable recovery over the medium term hold promise.

Ethiopia remains one of the poorest countries in the world subject to frequent adverse climatic conditions, volatile commodity prices and extremely low productivity. The authorities face a formidable challenge in creating the conditions for strong and sustainable economic growth that may alleviate poverty and improve the well-being for the population at large. Maintaining the structuring reform momentum and macroeconomic stability are key for enhancing productivity growth in the agricultural sector, that should remain one of the authorities´ overriding objectives.

On the fiscal front, the estimated increase in the overall fiscal deficit for 2001/2002 presents cause for concern. Though higher spending in priority social areas financed through concessional loans may account for this deterioration, we wonder, however, whether the current stance is consistent with fiscal sustainability over the medium-term. The difference in projections between the PRGF-program and the PRSP may suggest that an improvement in the fiscal position for 2004/2005 is not self evident. The need to increase poverty alleviation programs in Ethiopia is incontrovertible, but it is certainly not an easy proposition to achieve. In this regard, judicious resort to financing under concessional terms and higher donor assistance are crucial for Ethiopia's macroeconomic stability and external debt sustainability. At the same time expenditure management, in the midst of serious capacity constraints, should be geared to improving the quality and effectiveness of poverty alleviation programs.

Having said this, it is nonetheless reassuring that the VAT implementation in 2003 and the improvements in tax administration may generate a substantial increase in tax revenue, and that better budget formulation, execution and reporting, as illustrated in Box 4 of the staff report, should be expected to improve public expenditure management leading to a more balanced fiscal position.

Despite a cautious management of Ethiopia´s monetary policy, the sustained fall in food prices has negatively affected poor agricultural producers. We encourage the authorities and donors to consider purchasing local cereals from food surplus regions in order to support prices and mitigate the adverse consequences on the income of the rural poor. As to the exchange rate policy, we commend the authorities for the progress made in liberalizing the foreign exchange market in recent months, thus eliminating distortions associated with excessive foreign exchange controls.

We acknowledge that strides were made in the financial sector, in particular the introduction of a new management team in the Commercial Bank of Ethiopia (CBE) to allow it to operate on a commercial basis. Nonetheless, much more remains to be done given the extent of the state´s intervention in the financial sector, with the quasi-monopoly position of the CBE. The combined effects of political interference that may fuel rent seeking activities and high levels of non-performing loans, due mainly to moral hazard behavior, undermine the effectiveness of the financial intermediation and the solvency of the financial sector in Ethiopia. We encourage the authorities to prioritize the gradual opening of the financial sector to foreign banks and enhance the competitiveness and efficiency of the system. We also welcome the importance given by the authorities to the development of micro finance institutions, in particular in rural areas. Nonetheless, their intention to transform these institutions into rural banks and facilitate their funding through commercial banks needs to be carefully managed, and supported by appropriate financial technology and supervisory practices.

The finalization of a participatory PRSP offered a unique opportunity to discuss relevant issues for combating poverty between the government, the NGOs and the donor community. We welcome the having focused the policy actions on agriculture, rural development and food security, considering the importance of the agricultural sector in Ethiopia and that 88 percent of the population live in rural areas. It is important that this dialogue continues to strengthen to advance with improved results and accountability.

We concur with the staff that there are areas where improvement find well-placed the recommendation to include in the first annual report a better articulation of the strategy for the promotion of private sector development as well as alternative—perhaps less optimistic—macroeconomic scenarios in order to better prepare for unexpected changes that may affect the normal execution of the strategy.

Given the complex Federal system of government and the special role of the *woreda* level in the distribution of poverty related relief, the envisaged improvements in monitoring hold the promise of greater accountability and lower instances of corruption. We encourage the authorities to prioritize the capacity-building efforts in order to improve both efficiency and effectiveness of public spending.

Finally, the challenges facing the Ethiopian authorities are enormous. We encourage them to persevere in their efforts to implement the structural reform agenda and to be able to take advantage of HIPC eligibility to put the economy in a sustained path of growth, poverty alleviation and social development. With these remarks, we support the proposed decisions.

Mr. Al Azzaz made the following statement:

Economic performance and policy implementation in Ethiopia have been encouraging. Not only has macroeconomic stability been broadly established, but a number of indicators show that the effect of structural reforms introduced in recent years appears to be taking hold. In 2001–02, growth was strong, inflation remained negative, and fiscal performance was broadly consistent with the program.

That said, Ethiopia remains one of the poorest countries in the world and faces major challenges. Continued pursuit of prudent macroeconomic policies and implementation of structural reforms are, therefore, essential to achieve higher and sustainable growth needed to reduce poverty. I will make a few brief remarks in that context.

I welcome the fiscal program's continued focus on reorienting budgetary resources toward poverty alleviation expenditures. I, therefore, support the widening of the fiscal deficit in 2002–03 to accommodate additional anti-poverty, social expenditure and the initial cost of restructuring the Central Bank of Ethiopia. In this regard, I am encouraged by the continued stress on the prudent management of spending, and on improvements in its quality, strengthening the federal, regional, and district administrative capacities for better coordination and simultaneous execution of sector development programs is critical for improving expenditure monitoring.

On the revenue side, I am encouraged by the progress made in the implementation of the tax reform program, including the advances made in the preparation for the introduction of the VAT in 2003. Here, the importance of Fund continued technical assistance cannot be overemphasized.

The monetary policy directed at maintaining a low inflation rate is appropriate. The projected rise in money supply should help achieve this objective while allowing adequate credit to the private sector. In regard to exchange rate policy, I welcome the progress made in liberalizing the foreign exchange market. This has facilitated Ethiopia’s adjustment to the sharp depreciation in the terms of trade over the past 2 years.

The authorities should maintain the momentum for implementing the comprehensive strategy to improve the soundness of the financial sector and strengthen its competitiveness. A priority here is to ensure the prudent management of the still dominant Commercial Bank of Ethiopia and the National Bank of Ethiopia. Indeed, an increased competition in the banking system, a stronger regulatory framework and a more effective supervision of banks are critical for greater efficiency. That said, the envisaged reform strategy is extensive and will require a strong effort to implement. Here, close staff monitoring of the progress with appropriate technical assistance is critical for successful implementation.

On the broader structural reforms, I welcome the importance the authorities’ attach to strengthening the legal and regulatory framework for market-led growth. I am also encouraged by the ongoing efforts to improve public sector management and advance private sector development. The authorities' intention to accelerate the privatization program also bode well for growth prospects.

Finally, I welcome the finalization of the full PRSP after a wide and full participation by civil society and development partners. I agree with staff on the agenda for further improvement of the strategy as detailed in paragraph 32 of the joint staff assessment report. In particular, further articulation of the strategy for promoting private sector development and a refinement of costing of PRSP programs I share staff's view that the PRSP provides a sound basis for Fund confessional assistance.

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

Mr. Kpetigo made the following statement:

I would like to thank the staff for a well-written report, and Mr. Rustomjee for his comprehensive statement. Ethiopia continues to make significant advances since 2000, and is embarking on a Fund-supported PRGF program. So far, achievements have been impressive, with the implementation of wide-ranging structural reforms, and prudent macroeconomic policies. We commend the authorities for these achievements. The high level of poverty constitutes the major problem facing Ethiopia. Thus, the authorities' determination to achieve high real GDP growth over the medium term is encouraging, and the proposed medium-term framework for 2002–2005 reinforces their commitment to comprehensive structural reforms.

The authorities expect annual GDP growth of about 6 percent, while inflation should remain at 3 percent. In the real sector, this rate of output growth hinges on several assumptions over the medium term, including a steady increase in investment, the implementation of sound policies, and continued foreign financial assistance. This should be assisted by the growth of agricultural output and exports. Inflation is projected to rise to 4.5 percent with larger than anticipated official transfers, while the external current account deficit for 2001–02 is estimated to be lower than projected.

Regarding the fiscal position, in the context of lower nominal GDP, the budget deficit is projected to reach 9.9 percent of GDP, and it is encouraging to note that the authorities are determined to pursue a prudent fiscal policy stance, and to persevere with their cautious expenditure policies. However, it is clear that a significant reduction in the fiscal deficit for the 2003–04 fiscal year will be critical. Therefore, we strongly encourage the government to introduce the value-added tax as scheduled in January 2003, and to continue their efforts to improve the tax administration. The implementation of tax reforms will be essential in order to meet revenue targets. We commend the government for their progress with the new larger taxpayer units, and their improvements in the planning, tracking, and reporting of public expenditures, and augmentation of poverty alleviation spending.

In the financial sector, the monetary program for 2002–02 was updated in order to achieve a lower rate of inflation, the international reserves targets, and to enhance the competitiveness of the financial sector. The government's recourse to banking system has been limited in order to provide more resources to the private sector. We share the staff's view that the authorities should keep interest rate policy under review, while maintaining positive real interest rates. Measures aimed at reducing nonperforming loans, strengthening the NEB, and enhancing the privatization process are, in our view, the right policies; these deserve our support. We also support the staff's recommendation to enhance competition in the financial sector.

Concerning the external sector, the authorities have continued to pursue a flexible exchange rate policy under the program, while the NEB has substantially reduced its participation in the foreign exchange market. The depreciation of the currency and the progressive recovery of coffee prices should facilitate export growth. The authorities are to be commended for their progress in eliminating most of the previously identified exchange rate restrictions, and for having maintained the appropriate exchange rate regime and associated policies.

Regarding the issue of enhancing competition in the financial sector by allowing foreign participation, we are pleased to hear from Mr. Rustomjee that the authorities favor a gradual approach. With these remarks, we support the proposed decision and wish the authorities every success.

Mr. Zakharchenkov made the following statement:

Ethiopia has continued making progress under the Fund arrangement. All quantitative performance criteria and structural benchmarks for December 2001 and March 2002 were observed. The completion of all prior actions for today's review further underscores the authorities' commitment to the reform process and adds credibility to their reform efforts. Consistent implementation of the Fund arrangement has already started to bear fruit in terms of some improvement in living conditions of the population, particularly in the rural areas. It is encouraging to note progress in normalizing relations with neighboring Eritrea that allowed for a 5.9 percent of GDP cut in defense outlays and subsequent doubling of poverty-related spending. All these developments indicate that the program remains on-track and we have no difficulty in supporting the completion of the review.

I broadly agree with the staff's assessment of macroeconomic developments and with the proposed policy actions. Therefore, I will be brief and will comment only on several important issues.

In the fiscal area, we recognize that considerable widening of the fiscal deficit this year was, perhaps, necessary to provide some stimulus to the economy and to sustain growth momentum. However, in the period ahead it will be essential to bring fiscal position back on a more sustainable footing and we urge the authorities to continue their fiscal consolidation strategy in the next year's budget. I noted a significant improvement in the revenue collection. The establishment of a large taxpayer unit and the anticipated introduction of the VAT will further strengthen public finances. One also has to acknowledge significant progress in improving the planning, tracking and reporting of public expenditure, as noted by the staff in Box 4. With respect to the fiscal decentralization, let me stress that the authorities should improve budget monitoring and reporting capacity at the local level before proceeding further in this area.

We welcome bold steps undertaken thus far to improve the soundness and competitiveness of the financial sector, in particular, efforts to address governance problems in the CBE. I have some sympathy for the authorities' gradualist approach to improving competition in the financial sector, but, as rightly noted by the staff in Box 2, given the dominant position of the CBE, measures proposed by the authorities are not likely to radically change the present situation. Perhaps, the staff's call for allowing the entry of foreign banks into the country's financial market merits further consideration by the authorities.

Like other Directors, we welcome the preparation of the draft PRSP which forms a sound basis for the Fund's concessional assistance to the country. It should be noted, however, that there are several discrepancies in the fiscal projections between the PRGF and the PRSP, the latter being built on a rather optimistic assumptions. Here, let me say that the authorities should be cautious and conservative in their assumptions, and should follow spending limits that are incorporated in the PRGF-supported program. Any additional poverty-related spending should take place only if additional bilateral assistance becomes available.

Finally, let me commend the Ethiopian government for its intention to participate in the GDDS. Here, let me also underscore the importance of the adoption of a comprehensive debt-management strategy and the need to improve the quality of debt statistics. We acknowledge the progress made thus far in liberalizing Ethiopia's economy and we urge the authorities to eliminate remaining foreign exchange restrictions.

With these remarks we wish the authorities further success.

Mr. von Kleist made the following statement:

We are pleased with Ethiopia's performance under the first annual PRGF-supported program, while the second annual program seems to be on track. The authorities should be commended for pursuing prudent macroeconomic policies, and for implementing important structural reforms. Furthermore, I welcome the final version of the PRSP, which, if implemented fully, has a good chance of reducing poverty in Ethiopia. However, the challenges that the Ethiopian authorities face remain daunting. The economic situation in Ethiopia remains quite vulnerable, and there are many issues that one could comment on. However, at this stage of the discussion, I will restrict myself to three points.

First, there are widespread reports that due to a serious drought, Ethiopia is once again on the verge of famine. As I mentioned before, this is a disturbing development with possible repercussions on the authorities' prospects for achieving their macroeconomic targets, and for the program as a whole—this issue should have been addressed by the staff in the written information they have provided to the Board.

The Ethiopian authorities asked for help from the international community as recently as September 4, 2002. In this context, we urge the authorities to implement demand oriented precautionary measures and sustainable strategies in the agricultural sector in order to improve food security—to this end, Mr. Ralyea emphasized measures relating to roads and irrigation networks. Furthermore, I am puzzled by the counterintuitive apparent situation, whereby a serious food shortage seems to coexist with declining food prices—there did not seem to be an adequate explanation of this phenomenon in the staff report. Conversely, some regions of Ethiopia display soaring food prices of late. This could be explained by Ethiopia's lingering market impediments and underdeveloped infrastructure—I would appreciate it if the staff could comments on this issue.

Finally, I would like to join other speakers, including Ms. Nikitin and Mrs. Boucher, in urging the authorities to strengthen fiscal discipline, particularly through improved PEM. I would also like to encourage the authorities to redouble their efforts aimed at attracting foreign investment. Like other Directors, I would like to stress that after more than two years of negotiation, the expropriation claims that were mentioned in paragraph 38 of the staff report must be resolved—legal disputes of this kind are a major impediment to inflows of foreign direct investment. Furthermore, as other speakers have mentioned, foreign banks should be allowed to enter the market in order to promote competition in the financial sector.

Regardless, we should not forget to acknowledge the many positive developments in Ethiopia, despite the difficult circumstances faced by the authorities. Reforms in the areas of agriculture, private sector development, export promotion, and initial reforms to public expenditure management and control practices are all encouraging developments. Defense outlays have been cut to an impressive degree, though there is still some room for further reductions in order to ease pressure on the budget. The PRSP is characterized by an impressive degree of country ownership, and a broad-based participatory process. Perhaps most importantly, progress toward a lasting peace with Eritrea should be commended.

I hope that these encouraging developments will not dissipate, particularly if unfavorable weather conditions persist; thus, we urge the authorities to keep the PRGF-supported program on track. Furthermore, like other Directors, we feel that the PRSP lacks clear prioritization of development goals, and clear strategies aimed at reaching the goals that have been formulated. Moreover, vocational training initiatives that are included in the PRSP fall short of bilaterally agreed targets, which are linked to financing assurances.

In conclusion, we wish the authorities success in the future, and we support the proposed decision.

Mr. Kelmanson made the following statement:

We agree with the staff's overall analysis, and the proposed decision. I would like to comment briefly on the PRSP and the PRGF.

We consider the PRSP to be broadly acceptable. We welcome its focus on capacity building, decentralization, the importance of private sector development—particularly in terms of its emphasis on rural development—and the measures to promote trade. However, there are four areas where we would like to see the authorities concentrate more focus in future.

First, greater emphasis on monitoring arrangements is desirable, particularly with respect to the involvement of civil society in monitoring the implementation of the PRSP.

Second, the authorities should enhance the link between the PRSP process and the budget process. Furthermore, we hope that the donor community in Ethiopia and other participants can improve the coordination of their activities in order to improve aid management mechanisms, and to decrease the burden faced by the authorities.

Third, we look forward to the inclusion of participatory poverty assessments in the PRSP process—my authorities stand ready to support the government of Ethiopia and others in that effort.

Finally, as a number of other Directors have mentioned, we would also like to see the inclusion of alternative scenarios in the PRSP, as this will be particularly important given the vulnerabilities that Ethiopia faces in terms of food security. This will be an iterative process, as the authorities should attempt to make the PRGF more consistent with the PRSP, as the framework suggests. This will require close collaboration between the authorities and the staffs of the Fund and World Bank, as well as with other donors.

Regarding the PRGF, we agree with its analysis and proposals. We also agree broadly with Mrs. Boucher's comments. In particular, we welcome efforts to raise domestic revenues in order to improve the efficiency and level of poverty spending, and to constrain military spending. We also agree with Mr. Jonas in encouraging rapid reforms aimed at increasing the competitiveness of the financial sector—vulnerabilities in this sector must be addressed and monitored very closely by the staff.

Regarding the PRGF documentation, the text-box on public expenditure management was very helpful, as well as the section on conditionality, which outlined the situation very clearly. We also welcome the section on the discussions between the authorities and staff, which was very insightful. We would like to see the staff continue to include such information in future staff reports regarding other country cases, perhaps with more emphasis on various options that might be available to the authorities—I understand that the staff has committed to doing so in future PRGF documents.

Mr. Komatsuzaki made the following statement:

I would like to thank the staff for a well-written report, and Mr. Rustomjee for his informative statement. As other Directors have stated, I welcome Ethiopia's good performance under the PRGF, particularly their appropriate stance on macroeconomic policies, and progress toward structural reforms in the tax and foreign exchange areas, as well as the successful completion of the PRSP.

I agree broadly with the staff appraisal, and would like to make a few brief additional comments. As many other Directors have stated, I think it is necessary for the authorities to revisit their medium-term growth outlook, and to include less optimistic alternative scenarios.

Regarding the financial sector, I agree with Mr. Jonas's comments. It is important that foreign banks be permitted to enter the financial sector in order to promote efficiency and competition. However, I am unsure what impact foreign participation in the basic financial system might have at this time, considering that Ethiopia's banking system is currently in disarray, particularly in light of the fact that foreign banks withdrew from a management contract with the Commercial Bank of Ethiopia. Furthermore, I am unsure of the actual difference between this management contract and additional reform measures that might be envisioned. Regardless, the current state of the CBE highlights the importance of restructuring this institution. In this light, it might be useful to consider modifying program benchmarks and performance criteria, in line with Mr. Ralyea's suggestions.

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

> Regarding food security and the cereal market, we tried to provide some information about the complex situation in Ethiopia in the staff report (Box 1). In 2000 and 2001 Ethiopia produced a bumper crop of cereal products, and in 2001–02, production returned to more normal levels. Ethiopia received 500,000 tons of cereal in food aid from abroad, and produced about 10 million tons indigenously. Some regions had a surplus of cereal stocks, while other regions were beset by deficits—thus, approximately 5 million of the poorest Ethiopians will require food aid regardless of the level of domestic production. This stems in part from the fact that it is extremely difficult to move cereal from surplus to deficit areas, which only adds to the crises that Ethiopia has experienced over the last three years. Distribution problems and the fact that foreign food aid caused a two-year decline in domestic cereal prices, combined to create serious problems for Ethiopia. However, as Mr. von Kleist indicated, in the month of July, prices for cereal rose by about 4 percent over the previous month, and this trend is likely to continue.
>
> Various foreign agencies and the authorities are currently assessing the probable impact of a shortfall in rain. The authorities recently confirmed that a famine similar to those in some other Southern African countries is not likely to occur in Ethiopia. Regardless, preliminary estimates suggest that Ethiopia will require 200,000 tons in additional food aid in 2002. Some donors have already indicated their willingness to provide some additional assistance—including the U.S. The latest figures suggest that there may be a need for about 100,000 tons of cereal to meet the current shortfall in Ethiopia—donors including the Fund and World Bank will continue to monitor the situation closely—we will discuss this and other issues with the authorities in a few days.
>
> Regarding the financial sector, the termination of the management contract between a foreign bank and the CBE is a separate issue from that concerning the participation of foreign banks in Ethiopia's financial sector. We proposed that the authorities allow foreign banks to enter and operate in Ethiopia in order to compete with the CBE. We agreed with the authorities that, at a minimum, foreign assistance would be necessary to manage the CBE on a commercial basis. The contract between the foreign bank and the CBE did not work out, so an alternative solution is now being implemented, which involves the participation of a private consultant. This summer, the authorities implemented this strategy, which was considered a prior action. Bidding for this contract involves three banks that are interested in assisting the current management of CBE, in order to increase efficiency and ensure that the CBE

> is managed on a commercial basis. This is separate from the issue of competition, and the entry and participation of foreign banks.

Mr. Komatsuzaki thanked the staff representative for his remarks and clarification, and asked if there might have been a case for waiting until the CBE had benefited from foreign assistance before allowing foreign institutions to enter the wider financial market. Furthermore, according to the staff report, other countries such as Kenya, Sudan, and Uganda had positive experiences from allowing foreign banks to enter the domestic financial system. In this context, how had Ethiopia's banking sector compared to that of the other countries that had been mentioned?

The staff representative from the African Department (Mr. Tahari) replied that on the appropriate timeframe for the entry of foreign banks, the staff report included a box stressing that Ethiopia should act quickly to promote competition in the financial sector. Furthermore, the staff considered that the CBE would continue to dominate Ethiopian financial markets—the CBE was currently responsible for 80 percent of deposits and 70 percent of loans. Ethiopia's existing private financial institutions were locally owned, but were not sufficiently strong to withstand an influx of foreign competition. While restructuring of the CBE was necessary, it needed not precede foreign entry into the financial sector. The Ethiopian authorities were apprehensive about such liberalization, owing in part to the experiences of several other similar countries. The staff had explained to the authorities that these cases did not parallel Ethiopia's current situation, as those countries had been beset by high rates of inflation and macroeconomic instability at the time of financial liberalization. The governors of the central banks of Tanzania, Uganda, and Kenya had testified to the efficacy of such financial sector reforms in their countries, and had advised the Ethiopian authorities to expedite the process in their country.

Mr. Rustomjee made the following concluding statement:

> I would like to thank my colleagues for their written and verbal remarks, and also for their support of the proposed decision. I especially welcome Directors' encouraging remarks on the authorities' performance. They have been implementing a wide range of reforms for a number of years, which now appear to be taking hold. Several Directors mentioned the fact that the economy remains vulnerable to external shocks, particularly to terms-of-trade shocks. There was some concern over the impact of declining commodity prices on exports and the economy as a whole. The drought is another area of significant concern, and I acknowledge the staff's lack of sufficient on this issue data at present. I would suggest that when the data does become available, that the Board should be given an update, particularly in light of the staff's upcoming visit with the authorities here in Washington.
>
> While working with the Ethiopian authorities and several other similar countries over the last few years, I have come to observe that there are two major obstacles to reducing poverty in such countries, which must be addressed toward the beginning of the reform process. First, political

commitment to sound economic management and reform practices must be developed and entrenched, often in spite of the ancillary circumstances. The other challenge relates to developing a sense of ownership on the part of the country itself. In my judgment, Ethiopia has now overcome the first of these challenges, and is moving on to the second challenge. One dimension of this challenge is for the Fund to promote ownership of economic reform strategies.

This issue has been touched on by today's Board discussion, particularly in the context of the divergence between the PRGF and the PRSP projections. Here, the authorities seem to believe that they have addressed many of the challenges facing their economy, and feel ready to proceed faster along the road toward growth and reform. This strategy requires additional spending—a strategy that the staff, in their wisdom, view with some degree of skepticism. This is a healthy tension in the context of the Ethiopian authorities, who are firmly committed to reform.

The sequencing of the liberalization of the financial sector is emerging as a somewhat contentious issue. I was fortune enough to participate in a two-day seminar on this issue, which I found to be extremely valuable for both the authorities and the MAE. I think it provided the authorities with some possible solutions to uniquely African problems, particularly relating to the financial sector. As Mr. Tahari said, the authorities had the benefit of listening to representatives of other countries that confronted similar challenges about eight years ago—the Tanzanian governor's presentation was particularly insightful. The authorities are concerned that foreign banks will overwhelm the institutional structure of Ethiopia's financial sector—given the high concentration of deposits in the CBE alone, these seem justifiable. Ultimately, I am confident that the Ethiopian authorities are receptive of the advice from the staff and other African authorities, and that they will soon move toward the suggested reform path.

Some Directors noted the need to improve fiscal management, which remains crucial to maintaining a sound macroeconomic environment. I am pleased that some of my colleagues recognized that the authorities' decision to increase the fiscal deficit helped to sustain economic activity over the past year. However, Directors are concerned about excessive increases in expenditures, particularly in the context of the discussion about the difference between the PRGF and PRSP scenarios. I appreciate the concerns of Directors who noted that expenditures should increase only as additional resources become available. I also note that Directors urge the implementation of additional measures related to public expenditure management—as stipulated in Box 4 of the staff report.

Overall, I agree that the authorities must maintain a prudent fiscal stance, and that more ambitious targets to reduce military expenditures are desirable—I will convey these sentiments to the authorities. I will also convey

Ms. Rizzotti's support for the increase in capital expenditure, which is the type of issue that often escapes the discussion, as the Board focuses on issues that are of higher priority—increased spending on capital expenditures is an obvious sign of progress, as it represents an investment in future growth.

Regarding revenue issues, I note the comments of Directors who welcomed improvements in tax administration. The authorities must prevent a short-term decline in revenues by ensuring that the VAT is properly implemented. There is also a concern regarding a structural problem stemming from the fact that local governments expend much of the revenue collected by the federal government—this suggests that local government expenditures should be an area of scrutiny and concern.

Regarding the PRSP, I acknowledge the general comments of Directors who believe that poverty levels in the country remain excessively high, and that the promotion of an environment that is more conducive to growth is needed. In this context, there is certainly room for greater prioritization of reforms and other measures, and a need to address the sensitivity the economy to export price shocks. I also acknowledge comments from Directors who called for the authorities to develop alternative scenarios for their medium-term framework.

Regarding the private sector development strategy, section 8 of the PRSP addressed the comprehensive approach that is required, as well as existing bottlenecks to private sector development—the issue of export diversification featured prominently in this discussion. In this context, the inclusion of an explicit trade strategy within the PRSP would be a valuable addition.

I have taken note of the support for increased social spending, and the concomitant reduction in military spending, particularly the fact that these expenditures must be allocated efficiently. Furthermore, the authorities should place more emphasis on contingency planning, particularly in light of the vulnerabilities of the economy.

Regarding the financial sector, I note the support from Directors for increased competitiveness and foreign bank participation, in order to promote efficiency and a subsequent reduction in the wide interest rate differentials across deposit and lending rates.

The CBE should also complete the audit on schedule, and prepare a plan for restructuring. The supervisory function of the central bank should also be improved. The implementation of safeguards assessments, and efforts to promote micro-financing initiatives are also needed. The authorities should also pursue prudent debt management practices, while there is a need for more detail on the completion point triggers for the HIPC Initiative. More detail is also required on the status of debt relief by all creditors.

The Acting Chair (Mr. Sugisaki) made the following summing up:

Executive Directors concurred with the thrust of the staff appraisal. They noted that the authorities have made good progress in the implementation of sound macroeconomic policies and structural reforms. However, after the bumper crop in 2000–01, real economic growth is estimated to have decelerated from 7.9 percent in 2000–01 to 5 percent in 2001–02. Since July of 2002, Ethiopia has suffered from a drought, which is affecting food production and causing food shortages in some regions, as well as a rebound in cereal prices after a two-year decline. The authorities have subsequently requested additional food assistance from donors.

Directors observed that, as one of the poorest countries in the world, Ethiopia faces major challenges, particularly the achievement of sufficiently high rates of real GDP growth over the medium term to help reduce poverty. To this end, Directors encouraged the authorities to implement decisively structural reforms that enhance the efficiency of the economy and improve its competitiveness, and to continue with prudent macroeconomic policies, including a sustainable fiscal policy.

Directors noted that the largely agricultural-based economy is vulnerable to exogenous shocks, and shared the authorities' concern about the continued drop in producer prices of cereals and coffee. They encouraged the authorities to take action to mitigate the impact of these developments. From a long-term perspective, they considered that a key challenge for the authorities in the medium term will be to diversify the production base of the economy.

Directors underlined that a significant reduction of the fiscal deficit in the coming years is needed for macroeconomic stability and debt sustainability. They urged the authorities to persevere with their cautious expenditure policy, and stressed the need to pursue vigorously their efforts to improve the planning, tracking, and reporting of public spending, especially poverty-reducing spending. In this context, they shared the view that decentralization of public spending should be conditional on an improvement in the effectiveness, reporting, and monitoring of local government spending. Directors welcomed, however, the shift in spending from defense to the social and economic sectors since the PRGF-supported program was adopted in late 2000, and encouraged further steps in this direction.

Directors were encouraged by the authorities' efforts to mobilize tax revenue by strengthening tax administration and reforming the tax systems, noting the rise in the ratio of collections to GDP in the last two years. However, they considered that there is room for further improvement in revenue collection, and urged the authorities to continue to implement the tax reforms in a timely manner. They welcomed the planned introduction of the value added tax and the tariff reform in January 2003, and urged the authorities to step up the preparations for these measures.

Directors endorsed a cautious monetary policy stance to maintain price stability, sharing the staff view that the authorities should keep interest rate policy under review. They considered appropriate the current exchange rate regime and policy stance. Directors welcomed the elimination of certain exchange restrictions, and encouraged the authorities to further liberalize the foreign exchange market and eliminate the remaining restrictions.

Directors urged the authorities to pursue vigorously their efforts to strengthen the financial sector and enhance its competitiveness, and to improve monetary management. They welcomed the ongoing efforts to address the difficulties of the largest state-owned bank. Many Directors recommended that the authorities reconsider the existing policy of not allowing entry of foreign banks, stressing that foreign banks would bring more diversified lending and enhance bank efficiency by increasing competition.

Directors stressed the importance of implementing other structural reforms that are conducive to economic growth and poverty reduction, including agricultural reform, capacity building, export promotion, the strengthening of the existing legal and regulatory framework, and civil service reform. They encouraged the authorities to accelerate the privatization program in order to spur private sector activity.

Directors welcomed the completion of the full PRSP, which should substantially help Ethiopia's fight against poverty. They commended the authorities for the wide and full participatory process with civil society and development partners. They observed, however, that more prioritization is needed and that there are downside risks to the implementation of the proposed policies and reforms, including the vulnerability of Ethiopia to exogenous shocks. Some Directors noted that the PRSP projections might be overly optimistic, particularly in light of the pressures currently facing Ethiopia. Directors agreed that the medium term macroeconomic framework incorporated in the PRSP should be carefully evaluated once additional external assistance is identified.

Directors noted the progress being made in improving the macroeconomic statistics in line with Fund recommendations, and urged the authorities to intensify their efforts in this area. They welcomed Ethiopia's intention to participate in the General Data Dissemination System.

It is expected that the next Article IV consultation with Ethiopia will be held on the 24-month cycle, subject to the provisions of the decision on consultation cycles approved by the Board on July 15, 2002.

Points Relating to the Third Review of the Poverty Reduction and Growth Facility (PRGF) Arrangement

Executive Directors welcomed the satisfactory implementation of the second annual program under the three–year poverty reduction and growth facility (PRGF) arrangement. They noted that all the performance criteria and benchmarks for December 2001 and March 2002 were met, except that concerning the revision of regulations governing banks' provisioning for nonperforming loans. These regulations were brought more in line with international best practice in August of 2002. Directors therefore completed the third review under the arrangement.

Directors urged the authorities to maintain a prudent expenditure policy to limit the recourse to bank financing, and to steadfastly implement tax reforms so as to achieve the program's revenue target.

Directors welcomed the actions intended to make the Commercial Bank of Ethiopia more efficient by operating under a new management team and on a more profit-oriented basis. They supported the planned financial audit of the bank by an internationally reputable firm, and underlined the importance of preparing a financial restructuring plan based on the results of the audit. A few Directors suggested that the structural benchmark pertaining to the Commercial Bank of Ethiopia should be converted into a performance criterion.

The Executive Board took the following decision:

1. Ethiopia has consulted with the Fund in accordance with paragraph 2(dd) of the three-year arrangement for Ethiopia under the Poverty Reduction and Growth Facility (PRGF) (EBS/01/13, Sup. 2, 3/26/02) and paragraph 5 of the letter dated December 31, 2001 from the Minister of Finance and the Governor of the National Bank of Ethiopia, in order to review program implementation and reach understandings regarding the phasing of, and conditions for, further disbursements during the second year of the arrangement.

2. The letter dated August 19, 2002 from the Minister of Finance and Economic Development and the Governor of the National Bank of Ethiopia, together with its attachments, shall be attached to the three-year PRGF arrangement for Ethiopia, and the letter dated January 29, 2001 from the Minister of Finance and the Governor of the National Bank of Ethiopia, as

amended, shall be read as supplemented and modified by the letter dated August 19, 2002.

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

a. paragraph 1(cc) shall be revised to read as follows:

"(cc) During the second year of the arrangement, the fourth disbursement in an amount equivalent to SDR 10.429 million will be available on July 31, 2002, and the fifth disbursement in an amount equivalent to SDR 10.429 million will be made available on January 31, 2003 at the request of Ethiopia and subject to paragraph 2 below."

b. paragraph 1(dd) shall be revised to read as follows:

"(dd) The phasing of, and conditions for, disbursements during the third year of this arrangement shall be established in the context of the fourth review of Ethiopia's program contemplated in paragraph 2(dd) of this arrangement."

c. The introductory sentence to Paragraph 2 of the arrangement shall be revised to read as follows:

"2. Ethiopia will not request any disbursement specified in paragraph 1 above:"

d. paragraphs 2(aa), 2(bb), and 2(dd) shall be revised to read as follows:

"(aa) If the Managing Director of the Trustee finds that, with respect to the fifth disbursement referred to in paragraph 1(cc) of this arrangement, the data as of September 30, 2002 indicate that any ceiling or floor referred to in paragraphs 2(a)(i) through 2(a)(v) of this arrangement, as set out in Table 1 attached to the letter dated August 19, 2002 and further specified in the Technical Memorandum attached to the letter dated December 31, 2001, was not observed; or"

"(bb) if the Managing Director of the Trustee finds that, with respect to the fifth disbursement referred to in paragraph 1(cc) of this arrangement, Ethiopia has not carried out its intentions in regard to the introduction of the value-added tax as adopted by Parliament on July 4, 2002, as specified in Table 2 attached to the letter dated August 19, 2002 and paragraph 18 of the same letter; or" "(dd) until the Trustee has determined that, with regard to the fourth disbursement, the third review of Ethiopia's program referred to in paragraph 39 of the letter dated December 31, 2001, and with regard to the fifth

disbursement, the fourth review, referred to in paragraph 5 of the letter dated August 19, 2002, have been completed."

4. The Fund has reviewed the Poverty Reduction Strategy Paper (EBD/02/130, 8/28/02) submitted by Ethiopia and determines that it provides a sound basis for Fund concessional financial assistance.

5. The Fund decides that the third review contemplated in paragraph 2(dd) of the three-year PRGF arrangement for Ethiopia is completed and that Ethiopia may request the fourth disbursement under the arrangement on the condition that the information on the implementation of the measures described as prior actions in Table 3 of the letter dated August 19, 2002 is correct. (EBS/02/158, 8/21/02)

Decision No. 12858–(02/100), adopted
September 23, 2002

2. INTENSIFIED WORK ON ANTI-MONEY LAUNDERING AND COMBATING FINANCING OF TERRORISM—JOINT PROGRESS REPORT ON WORK OF IMF AND WORLD BANK

Documents: Intensified Work on Anti-Money Laundering and Combating the Financing of Terrorism—Joint Progress Report on the Work of the IMF and the World Bank (SM/02/290, 9/11/02; Sup. 1, 9/11/02; and Sup. 1, Cor. 1, 9/19/02)

Staff: Ingves, MAE; Johnston, MAE; Kincaid, PDR; Thony, LEG

Length: 1 hour, 35 minutes

The Acting Chair (Mr. Aninat) made the following statement:

This has been a very busy year for the Fund and the World Bank with regard to the issue of anti-money laundering and combating the financing of terrorism (AML/CFT), following the Action Plan laid out by the Executive Board and by the International Monetary and Financial Committee (IMFC) in November 2001. I am pleased to say that we have made very good progress in implementing all aspects of the Action Plan as described in the joint progress report that is before you.

We are on the verge of completing a comprehensive methodology to assess a global standard on AML/CFT and begin a 12-month pilot project to prepare associated Reports on the Observance of Standards and Codes (ROSCs). We will return to the Board as promised with a report following the Financial Action Task Force (FATF) Plenary, which is to be held from October 9 to 11 and will consider for endorsement the conditions outlined by the Board in July 2002 that must be met before we agree to commence this pilot project.

As you know, we have increased our technical assistance and strengthened our international collaborative efforts to increase technical assistance worldwide. We also recognize that strengthening AML/CFT regimes will require medium- and long-term efforts to strengthen capacity building, and that therefore more efforts will be necessary to enhance the technical assistance program.

We are advancing and implementing all the other aspects of the Action Plan. For example, the offshore financial centers (OFCs) program has been accelerated as we have already discussed before, we have incorporated AML/CFT elements as part of the Financial Sector Assessment Program (FSAP) and our offshore financial center assessments, and the Article IV questionnaires are being widely canvassed among the membership.

Following this meeting, we propose to forward the progress report, incorporating revisions from Executive Directors, to the IMFC.

Let me give the floor to the staff representative from the Monetary and Exchange Affairs Department for an update on where we are with regard to the comprehensive methodology and the 12-month pilot program.

The staff representative from the Monetary and Exchange Affairs Department (Mr. Johnston) submitted the following statement:

I would like to emphasize what the Acting Chair has just said. We have had a very intensive work program in implementing the Action Plan in collaboration with the World Bank, and there has been significant progress in all areas. The Fund membership and the international community has been very supportive of this work, and this ongoing support will be critical to us in the forthcoming FATF Plenary and as we further intensify our assessments and our technical assistance.

Let me briefly update you on our preparations of the comprehensive methodology and the 12-month pilot program of comprehensive assessments and ROSCs once the Board's conditions are met.

First, a draft of the comprehensive methodology was circulated for comments to FATF delegations and the Executive Board. A number of comments were received from Executive Directors and in consultation with them, they were forwarded to the FATF. The FATF has also received comments from FATF delegations. We understand that the comments are mainly technical in nature although a few delegations are concerned that the methodology goes beyond their view of the FATF Recommendations. A special working meeting will be held to review these comments in the margin of the FATF Plenary. The staff is also planning an outreach in the margins of the Plenary to brief FATF delegates about ROSCs, the Boards decisions, and the plans for coordination and review of assessments. The FATF Secretariat will circulate a final draft of the methodology this week and the FATF Plenary will consider the draft and the other conditions outlined by the Executive Board for endorsement on October 11.

Second, we have written to the FATF and FATF-style Regional Bodies (FSRBs) to prepare for the 12-month pilot program. The FATF and five FSRBs have so far responded. All are willing to participate in assessments using the comprehensive methodology and we are developing a preliminary schedule of assessments with FATF/FSRBs to avoid duplication of assessments. 15 OFC assessments and 19 FSAPs are scheduled to commence by the end of the fiscal year. We anticipate that a similar number of assessments may be undertaken by FATF/FSRBs. Allowing for overlap and avoidance of duplication, some 50 AML/CFT assessments could be undertaken during the 12-month pilot program. Responses from the FSRBs are indicating that FSRBs would not conduct their own assessments where there is a Fund/Bank-led assessment.

Third, the staff is advancing a roster of experts to assess the parts of the comprehensive methodology not under the supervision of the Fund/Bank. In particular, letters have been sent to the heads of the 27 FATF delegations requesting responses by September 27. Conducting the comprehensive assessments is predicated on an operational roster of experts and commitments by national authorities to finance these experts. With an operational roster and the schedule that we are developing, we would be ready to begin the pilot program once the conditions are endorsed by the FATF, and the Fund Board has finally approved the comprehensive methodology.

Mr. Reddy submitted the following statement:

Over the last one year, there has been substantial progress in implementing the mandate of the IMFC for intensification of AML-CFT work by the Fund and the Bank. We commend the staff for the enormous amount of work done in evolving the comprehensive methodology, requiring close consultations with the FATF and other standard setters, and seeking guidance of the Board on a continuous basis. We look forward to the commencement of the pilot program of AML/CFT assessments based upon application of this methodology, involving participation of the FATF and FSRBs. We welcome the inclusion of AML-CFT assessments as standard components of FSAP and

OFC assessments and the proposed increase in the number of the latter. We believe that these initiatives and the ongoing collaboration between the Fund-Bank and the FATF have the potential to enhance the effectiveness of assessments, expand their coverage, and promote a more efficient use of resources.

However, as we have said on earlier occasions, the success of this strategy, so crucial to the global endeavor to prevent the abuse of financial systems for money laundering and promoting terror, would depend a great deal on encouraging voluntary compliance through a collaborative approach. It is precisely for this reason that the Board's adoption of the 12-month pilot program and the addition of AML /CFT to the list of Standards and Codes was conditional. We look forward to the FATF's acceptance of those conditions. While we appreciate the fact that the FATF has agreed not to undertake fresh rounds of the NCCT exercise during the pilot phase, collaboration on an enduring basis would require that the FATF's approach continues to be guided by the same spirit.

As far as the content of the methodology is concerned, we agree that a comprehensive treatment of AML/CFT requires expanding the coverage to include non-prudentially regulated sectors. Securing requisite international cooperation for effectively tackling ML and FT and sharing of intelligence among countries also are of vital importance. Hence, we welcome the inclusion of these elements.

However, we would like to reiterate that there are exclusively sovereign functions that should be left to the respective national authorities to monitor, strengthen, and improve. It is neither necessary nor desirable to go into micro monitoring of the functioning of individual countries' legal systems, and prosecution and police agencies. Some of the elements of the proposed methodology, we are afraid, amount precisely to that. We refer here to the review of statistics pertaining to prosecutions, seizures, convictions etc and of aspects such as political control over enforcement agencies. Commenting on areas like ethical and professional conduct of lawyers, examiners, accountants, police officers, prosecutors and judges and the efficiencies of court system would also be neither warranted nor prudent. Outside assessments of legal systems may, in fact, not even be permitted in countries with judiciaries enjoying a constitutionally guaranteed independent and exalted status. Nor would institutions of professionals countenance such reviews. Additionally, such assessments could suffer from the disadvantage of drawing cross-country comparisons based on a statistical approach and without due account being taken of country-specific circumstances. The focus of the IFI's and the FATF's joint efforts should be on issues of macro-relevance having implications for systemic stability. We would urge, even at this stage, a review of such elements so that the proposed methodology is consistent with the mandate and expertise of the Fund and the Bank. It is not enough that such areas will not be assessed by the Fund-Bank staffs or by experts under their supervision. For, the revised methodology should ultimately result in assessments derived from consistent application of principles, a uniformly applied approach, and a neat division of labor.

We recall a clarification having been sought in an earlier Board discussion that just as FATF-led assessments would result in ROSCs, the Fund-Bank led assessments too should be accepted by the FATF. Any arrangement other than this would undermine the very basis of a joint approach aiming to promote efficient use of resources.

It is reassuring to note that corrective actions are being taken by a number of countries to address the weaknesses identified by their AML-CFT regimes. We are sanguine that this positive trend would continue. For many countries, these are relatively new areas and they may require an enhanced level of technical assistance to put in place the requisite institutional arrangements and systems. We, therefore, commend the substantial increase in technical assistance and the ongoing efforts for coordination of such efforts. While training to enhance the ability of the Fund-Bank staffs to deliver technical assistance is welcome, there should also be guidelines for the assessors to ensure that they focus on systems and outcomes rather than on statistics or "standard" procedures and formats. We also support the ongoing research and analysis work to obtain a better understanding of the underlying systemic causes of ML-FT related processes. In this regard, the draft paper based on a study of Informal Funds Transfer Systems throws up interesting issues for discussion. We would encourage the staff to continue such technical work but urge caution in drawing conclusions based on an incomplete appreciation of the local or regional context and adopting a prescriptive approach.

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

At our last Board session on AML/CFT, decisive progress was made regarding the extent of Fund/Bank involvement and the adoption of a comprehensive AML/CFT methodology. Notably, the addition of AML/CFT to the list of areas for which ROSCs may be prepared was apparently made conditional on completion of the drafting of the methodology by the FATF Secretariat, and on agreement to make its mutual evaluations consistent with Fund ROSC characteristics at the October FATF Plenary. Continued close cooperation will be essential given the long process involved in eradicating these forms of abuse of financial systems. Building on this basis, a 12-month pilot program would be launched. While awaiting the outcome of the FATF Plenary, we would like to comment briefly on the various lines of action discussed in the staff report.

Regarding AML/CFT issues in FSAPs and OFCs, we welcome the initiative to develop a template for standardized reporting to improve consistency. We are also encouraged by the fact that several member countries are taking actions in response to the findings of FSAP and OFC missions regarding weaknesses in their AML/CFT regimes. However, as the staff notes, despite progress in most jurisdictions reviewed, significant work remains to be done. In particular, as work in OFCs is a major component of international AML/CFT action, it is a matter of concern that almost no OFC jurisdiction has the supervisory resources needed for the degree of monitoring required by the methodology used in assessments.

The AML/CFT questionnaire provides, in principle, valuable background information on the legal and institutional framework for informed Article IV discussions. In this regard, three aspects should be singled out. First, there are indications that Article IV consultations are contributing to increasing awareness among the membership regarding AML/CFT issues and have triggered requests for technical assessments. Second, the staff notes that in several cases the responses were incomplete. We would welcome clarification from the staff on the degree of specificity in the design of the questionnaire, and its incidence on this outcome. Third, it can be concluded from responses to the questionnaire, that basic FATF recommendations are generally being followed—notably the requirements to report suspicious transactions and to keep records on clients for five years—but there also seems to be little progress in a central line of action, namely, the international sharing of information.

In this context, it is clear that efforts to build up capacity in the membership, through technical assistance and outreach should, constitute a centerpiece of the AML/CFT strategy. While fully recognizing the importance of AML/CFT technical assistance, we would like to reiterate the need to ensure that increased demands in this field not be met at the expense of technical assistance in other core areas. It is reassuring that an increasing number of countries is requesting technical assistance, and that the most demanded categories relate to critical aspects such as the establishment of financial intelligence units and the strengthening of supervisory systems—mainly from OFCs. One of the substantive agreements from the meeting with key providers and donors on April 22, 2002, was to coordinate technical assistance on a regional basis. In this regard, collaboration with the FSRBs seems to constitute an adequate platform for identifying technical assistance requirements and transmitting them to donors and technical assistance providers

We welcome the preparation of two regional conferences on AML/CFT, for South American countries and for Central Asian and Eastern European countries, respectively. The case of the multidisciplinary workshop for South American countries, demonstrates that collaboration with external partners—bilateral donors and regional agencies—is key both for increasing the breadth and effectiveness of the AML/CFT strategy, and for reducing the strain on the Fund's resources. We support the projected AML/CFT coordination meeting for later this year, to help sustain this critical line of action.

Lastly, the staff report notes that internal training at the Fund and the Bank has taken the form of briefing sessions for some 300 staff members thus far and that this will be supplemented with interactive media. In order to ensure that resources are efficiently used, this training program should be less concerned with the general aspects of the AML/CFT strategy and more focused on specific AML/CFT techniques and processes. In the same vein, we consider the research and analysis efforts—centered on the Hawala system and the AML/CFT legal and institutional frameworks—useful, and hope that the conclusions that may be drawn from them will be operationalized and effectively introduced into the AML/CFT strategy.

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

We thank the Fund and the Bank staffs for preparing a well-documented progress report, and highly value their efforts on AML/CFT issues in view of the events of September 11 and based on the Action Plan that was agreed to at the IMFC and Development Committee Meetings in November 2001.

We are pleased that the Fund and the Bank are expected to agree with the FATF on the comprehensive AML/CFT methodology, and that the Fund and Bank staffs are going to start AML/CFT assessments and associated ROSCs on a pilot basis for twelve months, in co-operation with the FATF and the FATF-style regional bodies (FSRBs). We believe these are the great outcomes of serious efforts by the Fund and Bank staffs. Japan intends to support this initiative strongly at the FATF Plenary this October as well.

In implementing the pilot program, we think it important that the Fund and Bank staffs embark on the work necessary to ensure that the mutual evaluations by the FATF/FSRBs and their reports are consistent with Fund/Bank-led assessments and associated ROSCs. In this regard, we hope that both staffs will continue close consultation with those bodies on the modalities of the Fund-Bank review of mutual evaluations. We also stress the need for strengthening the dialogue between the Fund/Bank and FSRBs, because the latter are starting to carry out AML/CFT assessments and associated ROSCs.

Following the adoption of the comprehensive methodology, we think it necessary that the Fund and Bank staffs review and update the questionnaires that have been used in assessing AML/CFT measures on the occasion of the Article IV consultation, the FSAP, and OFC assessments, with a view to making them consistent with the new comprehensive methodology. Internal measures such as staff training are also essential to ensure the quality of Fund/Bank-led assessments.

Finally, our authorities are committed to cooperating actively with the Fund and Bank staffs in their AML/CFT assessments, and the Government is currently in the process of choosing and nominating experts in the area of implementation of criminal laws.

Ms. Lundsager made the following statement:

The Fund and the Bank have responded in a comprehensive manner since the call for action from the IMFC last fall. The progress report details a number of steps that the Fund and the Bank have taken, as described by the Acting Chair earlier. We commend the efforts of the staff and management in working on these issues in a pragmatic manner with the FATF, other standard setters, and technical assistance providers. I thank the Board for its strong support and for working with their constituencies in responding to the IMFC request for information, which generated over 150 responses.

Turning to some specific issues in the progress report, we concur with the comment of Messrs. Yagi and Miyoshi regarding the need to continue the close collaboration with the FATF and FSRBs in anticipation of agreement on the pilot program for the ROSC based on the single comprehensive methodology. It is important to 'hit the ground running', given the limited timeframe of the pilot program and the intention to submit an interim report to the IMFC and Development Committee at next year's Annual Meeting. Like Mr. Yagi, we encourage the staff to work with the FSRBs to ensure that they have sufficient expertise to conduct high-quality assessments. At the end of the pilot program, we can then make an informed judgment about the overall process in consultation with the FATF and the FSRBs.

The report indicates that FSAPs and OFC assessments have revealed a number of weaknesses in AML/CFT regimes. Several countries and OFCs have taken actions in response, and we encourage all members to make this an ongoing priority. Messrs. Zoccali and Le Fort provided some detail on this issue, and also reminded us that our countries need to work together to share information in the area of AML/CFT.

The coordination of technical assistance is an essential part of the global effort, given the high resource costs involved and the need to target technical assistance on areas of the highest priority. We welcome the efforts of the Bank and Fund to engage with others, including the FATF, the U.N., and regional development banks. We also welcome the outreach to developing countries, which will help reinforce efforts of the Executive Directors to provide information on the various ongoing initiatives. Additionally, we note and support the on-going efforts to upgrade capacity of the Fund (and Bank) staff to deliver technical assistance on AML/CFT issues. We would note that our authorities have allocated substantial and growing financial resources to technical assistance and training associated with combating money laundering and other financial crimes, including terrorist financing. In fact, Congress has approved two supplemental budget measures in the past year to supplement ongoing efforts in this area.

We welcome the intensification of the Fund's and the Bank's research efforts, including by both the Research and Legal Departments. The study on hawalas and other informal transfer systems was well done, and we encourage further work on this topic. It may also be useful to juxtapose work on hawalas with assessment of the formal financial sector. Drawing financial transfers into the formal sector would facilitate monetary policy implementation, as well as enable regulators to do their jobs better.

We welcome the update regarding the results of the AML/CFT questionnaire, which was distributed to a number of countries as part of the Article IV consultation process. The questionnaires indicate that many countries have work to do to address weaknesses in their AML regimes, and particularly their CFT regimes. Of course, the questionnaire cannot assess the effectiveness and implementation of legislation. Thus, we encourage countries to take advantage of more detailed FSAP and ROSC assessments to delve into these issues, as well as to seek technical assistance.

With these somewhat forward-looking comments, we thank the staff and you, Acting Chair, for leading this effort. All our authorities will find this report very helpful.

Mr. Bischofberger made the following statement:

We welcome this very comprehensive and well-written joint progress report. The report appropriately summarizes the considerable progress that has been made by the Bank and the Fund in implementing the action plan to intensify work on AML and CFT issues. We commend the staff and management for the work already completed; and, of course, we are grateful for your substantial personal contribution, Acting Chair. We think that this progress report provides a good example of what the Bank and the Fund can achieve in specific areas in a relatively short time, if spurred by the political impetus from ministers and the IMFC and the DC. At the same time, we find it very useful that the report indicates the work that remains to be done in the respective areas in order to start with the 12-month pilot phase quickly, once the FATF has made the necessary decisions at its forthcoming Plenary.

We reiterate our support for the addition of the FATF 40+8 Recommendations to the list of standards and codes useful to the Fund's work. We are pleased with the cooperative manner in which the comprehensive methodology has been developed, bringing together the Fund, the World Bank, the FATF, as well as the FATF-style regional bodies. This is a promising base for a successful and coherent execution of AML/CFT country assessments and accompanying ROSCs.

We appreciate the two assessment methodologies that will be used for country assessments during the pilot phase, as they allow the Fund and the World Bank to limit their involvement to their respective mandates, while criminal law enforcement aspects will exclusively be assessed by external experts. This inter-institutional approach has in our view two additional benefits: First, it ensures the efficient use of scarce resources and limits budget implications for the Fund. Second, the two-pronged approach may result in a far greater number of countries participating in the assessments. However, as pointed out by Mr. Yagi and Mr. Miyoshi in their statements and Ms. Lundsager in her intervention, it is of utmost importance to ensure that mutual evaluations by the FATF/FSRBs and their reports are consistent with Fund/Bank-led assessments and associated ROSCs. Furthermore, duplication of work should be minimized through an as close as possible coordination between the Fund and the Bank and the FATF. In this respect, I very much welcome the staff representative's earlier remarks.

We emphasize the importance of those measures identified in the report that should accompany the fight against money laundering and the financing of terrorism, especially the need for accelerated capacity building through the provision of technical assistance. We acknowledge that coordination of technical assistance measures on the regional level is carried out by the FSRBs. As there exists a similar coordination mechanism within the United Nations, we urge the staff take also into account this coordination when planning technical assistance activities.

Finally, we are looking forward to an interim review in fall of 2003. This interim report should also focus on the budgetary implications of the exercise and provide the Board with a detailed cost-benefit analysis.

Ms. Manno made the following statement:

We welcome this report, which in a very clear and concise way summarizes the great amount of work that the Fund and the World Bank have been doing over the last year.

Management, and you personally Acting Chair, the staff and, if I may say so, the Board, should be commended for having achieved such impressive results in such a short time and especially in such a sensitive area.

Of course, these results have been made possible by the decision of a great number of countries worldwide to endorse the FATF Special 8 Recommendations and to join the self-assessment process. Several initiatives in different contexts, such as the Asia-Europe Meeting (ASEM), for example, are there to testify to the importance countries attach to combating money laundering and terrorist financing issues.

Turning to the report in front of us today, I think it accurately reflects our past decisions and lists all actions that we expect to be taken in the near future. The report also contains interesting new and useful information in particular on the questionnaire exercise and on technical assistance. I will comment briefly on these.

On the questionnaire, we have some comments with regard to procedure and substance.

We welcomed the initiative and were among the first to respond. We are now glad to see that it produced results in terms of being able to draw some general broad conclusions, and we therefore encourage those who have not responded so far to do so, that we might have a more comprehensive picture to look at during our next review. There are of course limitations, which are clearly highlighted in the report, and perhaps the amount of work the staff had to do to analyze the replies and the pages of laws and regulations sent to them is not proportionate to the results. It was difficult to understand from the report whether this exercise in fact entails more costs or benefits and whether we should continue to pursue this approach in countries that will not be subject to a more in-depth FSAP or OFC assessment. Comments from the staff would be welcome. That said, while we do sympathize with the difficulties for the staff and member countries as well, we believe like Mr. Zoccali and Mr. Le Fort that the questionnaire will perform a useful function of enhancing awareness and forcing countries to focus on this important issue.

On substance, we were bothered by the fact (and here we share again Mr. Zoccali and Le Fort's view) that the questionnaire responses provided little information on international exchange of information pertaining to suspicious transactions or terrorist financing. We would be interested in knowing more about this, as we believe exchange of information is crucial to effective AML. Second, we were surprised to read that there were only two requests for additional technical assistance from countries that replied to the questionnaires. Not that we are short of technical assistance requests, as is evident from the lengthy paragraph on this topic.

We found the part on Technical Assistance to be the most interesting. It is very instructive and dissipates the impression we had that not much had been done, given the constant call of countries for more technical assistance.

> Certainly, this is also one of the areas where most of our work still lies ahead, as we have to make operational several initiatives that aim at improving capacity building and providing technical assistance. We welcome the important efforts toward coordination, particularly with the FATF-Style Regional Bodies. The attempt to become a sort of "clearing house" for technical assistance is quite a challenging, but positive, development.
>
> What we did not like was the report's failure to mention efforts from bilateral donors in providing resources for technical assistance. As stated on previous occasions, Italy has established a Trust Fund with the purpose of providing technical assistance in particular in the area of AML. This information should be added to the report not only because it concerns my country, and possibly others, but also more generally because it shows that donor commitments to help in the provision of technical assistance do not only come in word, but in deed.
>
> Speaking of alternative sources of financing for technical assistance, it would be beneficial to explain, in a footnote perhaps, what this FIRST initiative is. I, for one, have only a vague idea.
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> We welcome the increased pace of offshore assessments, which is being doubled in 2002, as well as the template being developed by the staff for standardizing reporting of AML/CFT assessments in both FSAPs and OFCs.
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> Finally, like Ms. Lundsager, we were pleased to read in the report that following our Board decision to have a 12-month pilot program, the Fund and the World Bank are already—as we urged them to do last July—actively trying to put into practice the two methods suggested for collaboration with the FATF and FSRBs. We are looking forward to a comprehensive review of those experiences at the time of the 2003 Annual Meetings.

The Acting Chair (Mr. Aninat) noted that the paper would be corrected to include the names of the donor countries that were providing resources for AML/CFT technical assistance.

Mr. Callaghan made the following statement:

> The speed and depth of the response to the IMFC's call to combat money laundering and terrorist financing by the Bank and the Fund and its members is well highlighted in this progress report. Importantly, the issues have been advanced in a pragmatic fashion, and that has been the key to being able to make progress. There is a danger, however, that reactions to this report may not focus on the considerable progress that has been made, but on the shortcomings that are identified, and the results of the questionnaire indicate that substantial weaknesses in members' AML/CFT frameworks do exist.

With this in mind, what needs to be emphasized is that efforts by members to strengthen laws and institutions is widespread, and there is a political commitment there, but we do need to be very realistic about the extent and pace of progress that can be made, particularly in countries where financial systems are not well developed. Progress towards the objectives we have set our members will be a challenge. In some areas it will take time, particularly where changes to legislation are required and institutions need to be built where none existed before. I think this should be made clear in the report, that this is a long haul operation. It is important that responses developed are appropriate to the circumstances and as such are durable, as others have emphasized, technical assistance is going to be vital in this regard.

We do need to communicate clearly that the assessment process is not there simply to identify weaknesses. The focus should always be on developing a pragmatic strategy for developing legal and institutional frameworks that are suitable for each country and can be maintained effectively. In this regard, it would be good if the report was a little bit more direct in outlining how, for example, the questionnaire will be used to assist members in strengthening their AML/CFT frameworks. I had, I think, a similar impression that Ms. Manno was referring to in looking at the conclusion of the supplementary paper on the questionnaire. It does seem to be a little ambivalent as to whether it thinks the costs of the questionnaire are offset by the benefits that are derived from it.

We have a 12-month pilot period in terms of AML/CFT assessments, and this does have to be handled carefully. The last thing we want is for members to become reluctant to self-identify weaknesses and seek assistance in strengthening their frameworks against the fear that in doing so they may be exposing themselves to penalties. One query I would raise on the questionnaire is given the experience to date, is there any need to look at revising it to ensure that all the relevant information is obtained? It is also important to highlight that the Bank and the Fund are only part of the international response to combating AML and CFT, a point that has already been raised by Ms. Manno and one I think you said you were going to pick up, Acting Chair. I think that is very important. As we know, cooperation between the various bodies involved is vital to ensure that the resources are deployed as effectively as possible and to prevent regulatory overlap in the burden this imposes on our members, particularly the smaller members. Importantly, as others have emphasized, close cooperation with the FATF is essential, particularly in the 12-month pilot program for AML/CFT assessments, and for this to provide a positive base for the future. I think the information that the staff representative from the Monetary and Exchange Affairs Department outlined this morning is extremely interesting, and I hope that this is incorporated into the report. It does answer some of the missing elements and provides a more solid foundation that we do have good cooperation going forward. This is going to be a long process, and in looking ahead, it is vital we maintain the principles underlying the ROSCs. What happens after the 12-month pilot period depends crucially on whether the FATF decides to make its processes compatible with the ROSC process. We and the FATF should always be very mindful of this fact.

Mr. Boitreaud made the following statement:

We welcome this very comprehensive progress report on the work achieved by the Fund and the Bank on AML/CFT. It provides a very good overview of the progress the two institutions have been able to achieve in a limited amount of time. This includes the progress made on the methodology and the efforts to increase the awareness on AML/CFT, both within the institutions and outside them.

As noted in the paper, this discussion is the fifth one our two Boards have had on AML/CFT since November 2001. Those debates have led to a shared understanding of the importance of these issues, and have helped build consensus on the legitimacy of the Bretton Woods institutions to tackle them. They have also created a better understanding of the methodology and procedures used to assess AML/CFT. They have allowed for a clear recognition that the Bank and the Fund should increase technical assistance in order for those countries willing to improve their legislation to have access to the best knowledge and expertise. Today, AML/CFT issues are in the process of being streamlined through the work of the two institutions, both in the Article IV process and the Country Assistance Strategies (CASs). The staff and management, especially you, Acting Chair, should be complimented for the work already completed, and this progress report provides a good example of what the Bank and Fund can achieve to promote financial stability spurred by the political impetus from Ministers at the IMFC and the Development Committee.

As Mr. Bischofberger, we are heartened to note the convergence toward a comprehensive AML/CFT methodology that will hopefully be finalized by October 2002, and which reflects a common standard covering the FATF 40+8 Recommendations. We have already fully endorsed adding the FATF 40+8 Recommendations to the Bank/Fund list of standards and codes and adopting a ROSC based on those Recommendations.

On the four conditions listed in paragraph 17, our understanding is that conditions 2, 3, and 4 have already been agreed to by the FATF and that condition 1 should be met in October. The Bank and the Fund staffs should then be in a position to begin the 12-month pilot study, which would provide an excellent opportunity to add to past experience and inform our next discussions with concrete cases. It will also contribute to improve working relations between national experts and the Bank and the Fund staffs as well as further smooth the cooperation process between the FATF and the Bretton

Woods institutions. The staff representative's remarks at the outset of this meeting bears witness of the quality and extent of this cooperation now.

As stated by Mr. Yagi and Mr. Miyoshi, Ms. Lundsager, Mr. Bischofberger, and Ms. Manno, it will be of crucial importance at the end of the 12-month pilot period to have a precise and comprehensive look at the quality of both types of assessments. This review process should be conducted very candidly and in an open spirit in close association with the FATF and the FATF-style regional bodies.

We have noted with satisfaction the steps taken to intensify the coverage of AML/CFT issues in the FSAP, OFC assessments, Article IV consultations, and in the World Bank CAS. We see in the attention given to AML/CFT throughout the work of the Fund and the Bank an opportunity to identify weaknesses, and for the two institutions to recommend appropriate steps to be taken in order to improve AML/CFT regimes. Identified gaps should lead to appropriate technical assistance.

Mr. Faircloth made the following statement:

The progress report shows that the implementation of the intensified Action Plan to combat money laundering and terrorism finance is well advanced, as well as that the various initiatives continue to respect institutional mandates and core areas of expertise. We are especially encouraged by the decision in principle to add AML/CFT to the list of codes and standards as well as the near completion of a comprehensive assessment methodology and the agreed pilot procedures for preparing an associated ROSC. These notable achievements are founded upon the broad based recognition that money laundering and terrorist financing do constitute a significant threat to the financial systems and macroeconomic stability of member countries. They are also a testament to the cooperative nature of this institution and this Board's willingness to engage in consensus building. Of course, recent progress would not have been possible were it not for the dedicated and commendable efforts of both management and the staff as well as the willingness of international standard setters such as the FATF to collaborate in good faith with the Bank and the Fund on this initiative.

With regard to the report itself, we believe it clearly details the implementation of the Action Plan and accurately sets out the main priorities going forward. As others, I would like to offer a few brief remarks looking ahead.

First, it will be important to begin the pilot phase swiftly, once the FATF endorses the methodology and agrees to the remaining conditions for the preparation of a ROSC. In this respect, it is encouraging that the Fund and the Bank staffs have already begun consulting with the FATF and the FATF-style regional bodies. As others, we believe that maintaining a close dialogue with these bodies is crucial to avoid a duplication of work, and we generally welcome the inclusion of regional bodies in this pilot.

Like Mr. Yagi and Ms. Lundsager, we also believe that the staff's continuing dialogue with regional bodies should be used to identify and correct any specific capacity weaknesses that might hamper the quality of assessments. Preserving the integrity of the pilot exercise should, in our view, be the primary consideration, and to that end we urge the staff to take appropriate steps.

Second, we are extremely pleased that the paper devotes almost half of its contents to the issue of technical assistance, capacity building, and client country outreach. The underlying objective is to strengthen financial institutions and supervisory capacities in member countries. Obviously, diagnosing weaknesses is only a first step in this process, and we generally concur with the comments of Mr. Callaghan that it will certainly be a long-term commitment on the part of all parties to strengthen institutions. With this in mind, we agree that some in-house expansion of capacity to improve on the delivery of technical assistance is important, but we associate ourselves with Mr. Zoccali and Mr. Le Fort's comments regarding the need to ensure that training resources are used efficiently.

Third, effectively managing the inevitable increase in demand for Fund and Bank technical assistance will be challenging. technical assistance delivery will need to be allocated on the basis of prioritization systems that are presently in place, but given the already significant excess demand for Fund technical assistance, the report rightly underscores the importance of establishing strong coordinating links with other potential technical assistance providers. We would like to request that the interim and final progress reports on the pilots include a stocktaking of the capacity building elements of the AML/CFT work. The stocktaking should include a summary of technical assistance follow up and an assessment of how the proposed coordinating mechanism is working in practice. In addition, although capacity building in client countries should remain the primary focus, I have already noted, as have others, that it may be necessary to build capacity in some FATF-style regional bodies. It would be useful if the staff could comment on what processes might be developed to achieve this objective.

Fourth, on the AML/CFT questionnaire, we agree that its use will help identify major gaps in legal and institutional frameworks as well as facilitate the prioritization of technical assistance needs. We support including an overview of findings in Article IV reports as standard practice. Over time, this section of the report should detail the initiatives that authorities have undertaken to strengthen regimes as well as summarize the technical assistance that has been provided and its overall effectiveness.

Finally, we support Mr. Yagi and Mr. Miyoshi's comments that the questionnaire should be updated to reflect the new methodology. However, even a revised questionnaire will be limited in terms of assessing the implementation of legislation, and we generally encourage countries to take advantage of the more detailed FSAP and ROSC assessments.

This constituency remains deeply committed to the fight against money laundering and terrorism finance, and intend to collaborate with the Fund and the Bank as they embark on the pilot phase. To that end, my Canadian and Irish authorities will be nominating experts to participate in the Fund- and Bank-led missions, and my Caribbean constituents will be actively involved in the assessment process, on the basis of their membership in the Caribbean Financial Action Task Force.

Mr. Tombini made the following statement:

We commend the staffs and management of the Bank and the Fund as well as member countries for significant progress achieved during the last six months on implementation of the Action Plan to combat money laundering and the financing of terrorism. Among this progress we highlight, in particular, the conditional addition of the FATF 40+8 Recommendations to the list of standards and codes considered relevant by the Fund, the conditional approval of a 12-month pilot project and AML/CFT ROSCs, the near completion of a new comprehensive and unified methodology, the efforts to increase and better coordinate technical assistance in this area, and the very positive response of member countries to the international efforts in these areas reflected by the use of the new methodology in 21 voluntary FSAPs, by the 49 responses to the detailed questionnaires on AML/CFT, and by the 152 responses by members to the Secretary's invitation regarding the steps taken by these members in response to the IMFC request. These are all very important achievements that show how much can be accomplished by a voluntary and cooperative multilateral approach to deal with global problems that require global responses. We must all be thankful to the member countries for their strong and prompt response.

At the same time, the threats posed by money laundering and the financing of terrorism as well as by criminal activities that generate most of these funds are very serious indeed. The abuse of the financial systems can potentially generate severe economic consequences, both nationally and internationally. Therefore, the international community has to build on the progress achieved so far.

We are concerned, for instance, with information contained in the report that there is virtually no OFC that has the resources needed for the degree of monitoring required by the new methodology. Similarly, we are concerned that the responses to the questionnaires indicate that half of the respondents have systems with significant material weaknesses or very rudimentary systems. In addition, as other Directors, we are concerned that only a few respondents have provided information in the area of international exchange of information, which is critical for the success of the anti-money laundering efforts and this process.

Regarding the questionnaire, we would like to ask the staff to update footnote 3 of Supplement 1, which indicates the list of countries that responded to the questionnaire. In addition to Brazil, Haiti, Suriname, and Trinidad and Tobago in our constituency, which appear as having responded, Colombia has also responded to the questionnaire. We would appreciate it if that can be updated.

We have two general comments on the report. First, we appreciate the fact that, consistent with the Board's instructions, the Fund will not become involved in assessing the implementation of criminal laws and that this criteria will be clearly mentioned in the document. Our understanding is that this applies to the Board as well. The Board should have no role in discussing law enforcement parts of the assessments that are undertaken by experts of other institutions. We would like to ask the staff to register this understanding in the document as well.

The second and final comment refers to the role and accountability of assessors from other institutions. Preserving the independence of those assessors from national authorities is an issue of utmost importance. We request the staff to comment on how this would be addressed.

After adjourning at 1:00 p.m., the meeting reconvened at 3:15 p.m.

Mr. Andersen made the following statement:

I am pleased to mark the 100th Board meeting this year by congratulating the staff and you, Acting Chair, for the commendable efforts in this area. When Ministers and Governors see this report in its updated version, I think there is good reason for them to be encouraged by the significant progress made in fulfilling the mandate from the Ottawa IMFC meeting last year. In particular, I welcome the progress in the joint efforts by the Bretton Woods institutions and the FATF to finalize a comprehensive AML/CFT methodology and the proposed ROSC. I am encouraged by the strong collaborative spirit demonstrated by the international community in this matter, with the institutions involved guided by the common goal to assist countries in their efforts to limit the abuse of the international financial system.

As noted by Mr. Yagi and Mr. Miyoshi in their statement and echoed by others, it is important to ensure that the mutual evaluations by the FATF and FSRBs and their reports are consistent with Fund/Bank-led assessments and associated ROSCs.

Let me also join Mr. Zoccali and Mr. Le Fort and others in emphasizing the importance of the international sharing of information.

I look forward to the finalization of the comprehensive assessment methodology and the FATF's endorsing of it in about a couple of weeks so that the 12-month pilot program can be launched.

While AML/CFT policies have been improved in most jurisdictions reviewed, significant challenges remain as the joint staff papers show in order to ensure the necessary strengthening of AML/CFT regimes worldwide. In this regard, capacity building, and, accordingly, increased technical assistance is essential, and the Fund and the Bank, in cooperation with other international organizations and donor countries, have an important role to play in identifying and responding to the needs for technical assistance. In this regard, I am pleased to note that the report will be updated to include references to donor contributions, as recommended by Ms. Manno.

Finally, I join others in looking forward to a comprehensive review of the experiences at the time of the 2003 Annual Meetings.

Mr. Kiekens made the following statement:

The staff deserves praise for its good work in implementing the Board's decisions of July 26, 2002.

Early this month the Board received the final draft of an integrated comprehensive methodology for assessing compliance with AML/CFT standards. It was prepared by the staffs of the Bank and the Fund in close cooperation with the FATF secretariat and other standard setters. This draft is in line with earlier drafts, but simplifies the treatment of the financial sector. I find this draft acceptable. I expect that during the plenary session of the FATF in October the members will adopt it for use in their mutual assessments, and that the Fund Board will shortly follow suit. I would like to receive in due course the annexes to the methodology that still remain to be drafted.

The integrated assessment methodology properly distinguishes those elements that will not be assessed by the Fund and the Bank because they concern criminal justice measures and international judicial cooperation.

I have noted the staff's report on all the steps taken to advance the staff's work in this domain. I would like to make the following comments.

The Bank, the Fund, the FATF, the FSRBs, and individual countries should now cooperate in establishing a schedule of assessments under Method I, namely FATF-led mutual evaluations, and Method II, which are the Bank/Fund-led assessments. As was announced during the July Board meeting, I expect that broadly equal numbers of assessments under each method will be conducted during the 12-month pilot period. At the outset of this meeting, Mr. Johnson announced that in the next 12 months about 15 OFCs and 19 FSAPs will be conducted, all 34 of which will include AML/CFT components. He also confirmed that a similar number of AML/CFT assessments will be conducted as mutual evaluations under Method I. However, he expects, during the pilot period, a total of only 50 AML/CFT assessments under the two methods combined. Could the staff clarify how these numbers add up?

I insist that countries should provide and pay for the national experts needed for all parts of the Bank/Fund led assessments, and particularly for assessing how effectively the judiciary enforces AML/CFT laws.

In Section IV(A) of its report, the staff claims that every FSAP and OFC assessment will cover AML/CFT issues. I would like to urge flexibility in this regard. It is not necessary for an FASP or OFC to include a Bank/Fund-led AML/CFT assessment, if for instance such an evaluation under Method I, i.e., a mutual FATF evaluation, has been conducted recently or is scheduled to be conducted shortly. It should also be acceptable for AML/CFT assessments that are part of an FSAP/OFC to be conducted under Method I. It should also be possible for a country to ask for a stand-alone AML/CFT assessment, just as France has conducted a stand-alone ROSC on the Basle Core Principles. I would like to know whether the staff can agree with me on this.

It was good to learn from the staff at the beginning of the meeting that mutual FATF evaluations will not be conducted when a Bank/Fund-led AML/CFT assessment has recently been conducted. This will be important for avoiding duplication of effort. However, as mutual evaluations are compulsory under the FATF's rules and will be conducted with the same guarantees as those led by the Fund and the Bank, I expect that Bank/Fund-led assessments should likewise be omitted shortly before or after the FATF mutual evaluations, or even better, for all members of the FATF and FSRBs.

Many countries have recently undergone AML/CFT assessments covering their financial sectors. However, assessing for these countries how the police and courts enforce the law has not yet been addressed. It should be possible for these countries to complete their AML/CFT ROSCs simply by adding this type of assessment.

In order to ensure consistency among assessments, the staffs of the Bank and Fund will review individual assessments conducted under Methods I and II, insofar as they relate to the financial sector. A similar review should be arranged at the global level by the FATF and the FSRBs, in order to ensure the consistency of all law enforcement assessments for individual countries. Such a review panel should also exercise oversight of the national experts who, in the discharge of their mission, are accountable not to their countries of origin but to an appropriate common review authority, still to be established.

Finally, I would like to join Ms. Manno and other Directors in asking the staff to report regularly to the Board on the technical assistance used by countries for AML/CFT, including the amounts provided by each multilateral institution and bilateral donor.

Mr. Yakusha made the following statement:

I very much welcome the progress made on the work on AML/CFT issues and appreciate related efforts by the staff and management. After the adoption of the methodology by the FATF Plenary, and the agreement by the FATF Plenary on the four conditions that we decided were important for our cooperation, we could finally start with the actual assessments under the pilot project. The report covers nearly all our discussions and decisions, although I have a few points of attention.

I look forward to receiving the actual program of assessments that will be done in the pilot stage. I understand that we received information from the staff this afternoon, but as Mr. Kiekens, I also have some problems in combining the numbers.

Linking AML/CFT assessments to the FSAP and the OFC program might be a good and efficient idea. I wonder if the upcoming FSAPs correspond to the countries that most urgently need to undergo the AML/CFT assessment? I would therefore suggest to be flexible so as to accommodate the greatest needs, even if that means that certain FSAPs will be done without a full AML/CFT module, at least within the pilot stage.

One issue that still remains open is how to approach the current group of countries that have been classified by the FATF as noncooperating. As I understand, the FATF may proceed with sanctions for this group of countries. If this is indeed the case, it would not seem to be very appropriate for the reasons mentioned by Mr. Callaghan this morning.

With regard to the recognition of technical assistance demand and supply, I would want to emphasize the need to prevent the different organizations or countries from starting their own separate coordination process and competing for the same international pool of anti-money laundering and terrorist financing experts. I would have a strong preference for keeping this coordination function in the hands of the Fund and the World Bank, as they are in the best position to determine the technical assistance needs from the country assessments that have been done.

Another important issue is the large technical assistance requirements that will result from this exercise. As the Fund and Bank's resources are limited, we may want to address more explicitly the necessity for members, the FATF, and the FATF-style regional bodies to provide adequate financial support as well as human resources to do the assessments and provide follow-up assistance as well. The IMFC meeting and the Annual Meetings will be a good occasion for countries to make commitments in that regard.

Mr. Varela made the following statement:

Like other colleagues, I believe the staff has prepared an excellent report. It reflects very well the current developments and the expected next steps on AML-CFT.

The IMFC and the Development Committee endorsed the action plan to intensify the Fund and Bank involvement in AML-CFT issues in November 2001. In less than a year, the main steps specified in that action plan have been practically concluded. It has been an impressive progress and the staff must be commended for it. Proper recognition must be given also to you, Acting Chair, for your leadership and personal involvement in this important subject. It should be highlighted that this work has been made in the context of a highly diversified membership and that it involved close contacts and negotiations with the international bodies specialized in these issues.

We fully support this process and we look forward now to the complete implementation of the action plan endorsed by the Fund and the CD, by taking the following steps:

First of all, by the official recognition by the Board of the FATF 40+8 Recommendations as the international standard to fight against money laundering and combating the financing of terrorism, and the addition of the AML-CFT issues to the list of standards and codes useful for the Fund and Bank work. Second, by the formal approval of the comprehensive AML-CFT assessment methodology. Third, by the immediate implementation of the 12-month pilot program of AML-CFT assessments and the accompanying ROSCs.

I particularly welcome that the AML-CFT assessments is going to be made on a temporary basis and that the staff will report to the Fund and Bank on the experiences with the pilot program. In one-year time, we will have the opportunity to assess whether the approach followed is correct or whether it needs some refinements or modifications. An area that will need to be carefully monitored is the split responsibility between the Fund and Bank staffs and external experts within the Fund-Bank led assessments, to see whether this is the best solution or further involvement of the Fund-Bank staffs will be needed.

Other area that would need careful monitoring is the development of adequate resources within the Fund and the Bank to cope with this new task. We need proper resources not only to implement correctly the new assessment methodology and the associated ROSCs, but also to intensify the AML-CFT assessments in FSAPs, offshore financial centers, and Article IV consultations, as well as to provide technical assistance to member countries that could demand international support of the Bretton Woods institutions.

As stressed by Mr. Zoccali and Mr. Le Fort, and also by many other colleagues, building up capacity in the membership must be a key element of the AML-CFT strategy. Therefore, the Fund and Bank should be ready to provide extensive technical assistance as the full implementation of the action plan takes place. Like other colleagues, I think that the provision of technical assistance should not be done at the expense of technical assistance in other areas. In this regard, adequate prioritization and coordination of technical assistance with external partners is essential. We encourage the staff to continue working closely with the relevant groups that could help in providing and coordinating technical assistance to member countries, particularly with the FATF and FSRBs.

We welcome the different outreach initiatives that are being planned and particularly the multi-disciplinary workshop for South American countries to be developed in cooperation with GAFISUD. Along the same line as with technical assistance, perhaps the outreach operations will need to be enlarged in the future.

We support the current work on research of the Hawala and other informal funds transfer systems. We think these studies are useful in order to fight illegal practices as they provide a better understanding of them under which circumstances they develop. Like other colleagues, we encourage the staff to consider further areas of research.

Finally, I note that the issue of information sharing among members could have received more attention in the report. This is an area that will need to be reinforced in the future. The Fund should step up its efforts to encourage members to improve their information sharing systems at the international level.

Mr. Scholar made the following statement:

I would like to give a very warm welcome to this paper and to thank the staff not just for its work on this paper but for all its work over the last year. As others, I think that agreeing to a single methodology and reaching conditional agreement on a pilot ROSC in only ten months since the Ottawa IMFC meeting has been a very considerable achievement, and is the result not only of excellent work by the staff, but also a very good collaborative relationship with the World Bank and with others.

Mr. Boitreaud mentioned earlier that we have had a large number of Board discussions on this topic, and as he and others have said, this has been a very important part of the success of the work. It has given us an opportunity to underline the importance that all of our governments attribute to this work. We have reached a shared understanding of the role of the Fund, and in reaching this consensus on the way forward, this Board has played an important part, and as others have said, you, Acting Chair, have also played an important part. I would like to thank you for your work.

I think Ministers will find this report very encouraging at the meeting this weekend and will give a very warm welcome to it. I think this will be an important message coming out of the meetings.

Looking ahead, the priority now, as several speakers have said, is to move rapidly to implementation. I hope we can do that quickly after the FATF Plenary has given the necessary assurances to enable us to proceed.

Looking beyond that, I would just like to pick up on three points that others have made. First, Mr. Kiekens is very right to set out the importance of setting a timetable of assessments looking forward.

Second, I join Ms. Lundsager, Ms. Manno, Mr. Zoccali, Mr. Varela, and a number of others in stressing the importance of exchange of information. All of the experience shows this is a very important part of the fight against money laundering and the financing of terrorism, and that will be an important part of the implementation moving forward.

Third, a number of speakers, including Mr. Callaghan and Mr. Faircloth, have mentioned the importance of technical assistance and capacity building. It certainly is going to be a long-term effort, and countries will require high-quality and extensive help to improve their systems. This is something that will demand very good coordination with other players, and it is something we want to keep under review as we move forward. It may be that this is one issue we would like to review before the full twelve months is up so we can ensure—as we move through next year—that all our provision of technical assistance is adequate.

Finally, like others, we look forward to reviewing next year the approach in the light of the experience that we will have gained by then.

Mr. Chatah made the following statement:

We welcome this opportunity to take stock of the work on anti-money laundering and combating the financing of terrorism that has been undertaken by the Fund and the Bank over the past year, particularly since the spring IMFC meeting.

The progress report appropriately highlights steps that have been completed as well as some pending issues and further work necessary in the period ahead. The considerable progress that has been accomplished over a relatively short period of time reflects not only the international consensus on the need for collective and decisive action in this area, but also the high degree of responsiveness that this institution has shown in answering the international community's call for it to play a significant role in this effort. It is, indeed, this perceived agility of the Fund and its periodic, close, and cooperative involvement with practically all countries that makes it understandable for the international community to turn to this institution when quick and universal action is needed. This, of course, says something good about this institution, but it also suggests that care should be taken to ensure that, in defining its involvement, the Fund should ensure that it is not veering too far beyond its mandate and core functions, that new responsibilities that are acquired do not translate into less effective execution of other responsibilities, and that expectations remain realistic as to what the Fund can deliver, notwithstanding the resourcefulness of its staff and its own responsiveness as an institution.

Over the past year, we have stressed these principles during the Board's consideration of the Fund's role in AML/CFT while, of course, fully recognizing the importance of effective and timely global action in this critical area. We are pleased that much of the concerns that had been expressed over time have been alleviated or at least reduced as discussions evolved on Fund involvement. As others, we are pleased that we have reached this advanced stage in the Action Plan, and we hope that pending issues with the FATF will be resolved soon, and we have listened to the positive information the staff representative provided earlier today. We also hope that any remaining concerns will be totally eliminated as the Fund moves to implement the framework and the methodology that have been developed.

We would like, however, at this stage to make a few selected observations on the report, again reflecting some of the principles and considerations I alluded to earlier.

First, in paragraph 13, the report indicates that the methodology has been developed on the basis of the Board's clear guidance that the Fund should not be involved in assessing enforcement of criminal laws. Given the importance that I think all Directors attach or at least most Directors attach to this point, this reference is quite appropriate and should be highlighted. In this connection, we have noted the remarks made by a number of speakers, especially Mr. Tombini and later on Mr. Kiekens. Now, along the same lines as Mr. Tombini and perhaps also Mr. Kiekens, we noted that, again in paragraph 13, the language used in describing the assessment of criminal law enforcement states that the implementation of criminal law, "will be assessed separately by experts not under the supervision of the Fund or Bank and who will have been identified by the FATF, FSRBs, the U.N., or others." Given the potentially sensitive nature of this issue, in our view it is important to avoid whenever possible any ambiguity in the process of assessment and the process of selection, and we have heard this morning the reference to a roster being prepared of experts that will be used for these purposes. We suggest that this sentence, if my colleagues agree, should, instead, be phrased slightly differently to say something along the lines that the implementation of the criminal law code will be assessed separately by "independent" experts, and here I would very much be interested in listening to the responses to the comments made by earlier Directors on this point. The report also states that the implementation will be assessed by independent experts, selected by, but not under the supervision of the Bank and the Fund, and who will have been identified by the FATF, FSRBs, or the U.N. The point here is to stress the independence, and I am not sure how the process will do that, but that is important, as is the fact that the selection is based on a process that has some accountability.

The second point is on technical assistance, and many Directors have commented on technical assistance. Clearly, the report highlights and emphasizes the substantial technical assistance implications of the whole exercise. The table on page 14 and other information provided to us show the magnitude of the technical assistance needs. Paragraphs 53 and 54 refer to the work being undertaken to train the Fund and the Bank staffs on these issues. It is indicated that 300 staff members have undergone briefings on AML/CFT. We have no doubt that these briefings—and I understand they are short briefings—are useful, but are they useful to sensitize the staff on an important element of Fund work? We should avoid creating any impression that such briefings would enable the Fund or the Bank staffs to, "provide advice and technical assistance on AML/CFT issues", which is the sentence in that particular section. Clearly, it takes more than briefings of this type to qualify anyone to provide technical assistance on matters of this type. Again, this is an example of where one should avoid any inadvertent creation of unrealistic expectations on what the Fund is able to do.

The third observation is in regard to the study on informal payments systems. We very much agree with the recommendations made in the study on such systems, namely that developing appropriate regulatory and supervisory frameworks requires, "a realistic and practical assessment ... of the specific country environment." We believe this also applies to AML/CFT assessments in general as well as to the relevance and realism of technical assistance aimed at helping countries develop corrective actions in this area. We share Mr. Callaghan's general remarks on this issue and the issue of capacity building. We do not have specific suggestions for any changes in the document, although we would have liked this consideration to be reflected somehow or somewhere in the report. We certainly hope that in implementing the framework, these types of considerations will be in the back of the minds of all involved.

Let me end by reiterating our satisfaction with the progress that has been achieved and, again, state the commitment of countries in our constituency to the success of the truly global effort to combat money laundering and the financing of terrorism.

Mr. Rouai made the following statement:

We welcome the comprehensive progress report on the AML/CFT action plan and take this opportunity to thank management and the staffs of both institutions for their hard work and, in particular, for their efforts to collaborate with other institutions to advance work on this important issue within the guidance and principles enunciated by the Board.

We continue to support the Fund's role and contribution, within its mandate and core areas of expertise, in the international efforts on anti-money laundering and combating terrorism financing. In this context, we support the comprehensive AML/CFT methodology and the conduct of assessment based on the ROSC methodology, provided that this approach remains uniform, voluntary, and cooperative.

Our authorities are also contributing to the international efforts in this area under the arrangements provided by the Secretary's Department. In addition, three countries of our constituency have completed the Article IV AML/CFT questionnaire.

Notwithstanding the good will and preparedness to combat money laundering and financing of terrorism, it is clear there are high costs to be borne by the Fund and the membership. Therefore, management is encouraged to keep the issue of budgetary implications under close review, in particular regarding the need to support countries' technical assistance needs for institutions building and to enhance national AML/CFT regulatory and legal systems.

This being said, we have a few specific remarks on the draft report.

First, the draft report does not give enough credit to efforts made by member countries against money laundering and financing of terrorism. For example, the action plans for combating financing of terrorism, regularly provided by member countries to the Secretary, should receive a wider distribution and, more importantly, be better used to fill the information gap at international level.

Second, it is important to ensure the success of the pilot project, and we shall observe the collaboration between the staff and other institutions. A number of countries have completed the FSAP exercise, and it would be interesting to know such cases will be treated under this pilot project.

Third, the outreach and regional conference program, prepared by the staff, does not cover the Middle East and the North African countries. The staff may wish to clarify.

Finally, I welcome the staff's work on informal funds transfer systems and note their understanding of the functioning of the Hawala system and their deduction that it responds to legitimate financial needs and offers a competitive and efficient channel for fund transfers. We continue, however, to support the staff's efforts in how to avoid the use of these systems by outlaws and to encourage countries to enhance further the environment for development of the formal financial sector.

Mr. Guetat made the following statement:

Like other speakers, I would like to thank the Bank and the Fund staffs for preparing this well-written report and their valuable efforts on AML/CFT issues based on our past Board meetings and the recommendations of the IMFC. We are now almost at the end of the first step of the process. The endorsement of the final draft methodology and agreement to other conditions for the preparation of the related ROSC by the FATF Plenary in October 2002 will give an important impetus to this process. However, there is still a long way to go, and we hope that the Board will continuously be informed of the different stages, including the conducting of the 12-month pilot program, a point stressed by Mr. Varela.

Turning to the report, the attached scenario and the various FSAP and OFC missions have already pointed out the major weaknesses facing national authorities in dealing with these new matters of AML/CFT. Moreover, reactions received from Article IV discussions have also been helpful in identifying technical assistance needs. In this regard, I would like to stress that there is still more work to be done with regard to capacity building in member countries, mainly in low-income countries, so as to make technical assistance delivery effective. We associate ourselves with Mr. Zoccali and Mr. Le Fort in reiterating the need to ensure that increased demands in this new field should not be met at the expense of technical assistance in other core areas. This is also a point stressed by Mr. Faircloth.

In the same vein, and to raise awareness, we welcome the organization of the three separate regional conferences in Africa this month, but we were quite surprised we were not informed of these conferences and would like the staff to give more information on this issue.

Mr. Low made the following statement:

As others have already mentioned, we have made quite significant progress on the work on anti-money laundering and combating the financing of terrorism. I have just a few comments regarding the progress report.

First, perhaps it is simply an oversight on the part of the staff, but I recall that the staff had mentioned at the beginning of the session that the Board's final approval of the comprehensive methodology will be required. However, I could not find that being stated explicitly in the report as remaining work to be done. I suppose maybe that is just a question of formality, but I think it is useful to state it in the report. While I note that a statement by the staff has been distributed that mentions this point, I want to highlight that it is probably useful to state this fact in the report itself, because it looks a bit strange to require the FATF to endorse the methodology but not the Board.

With regard to some of the comments on the questionnaire, I join Ms. Manno and Mr. Callaghan in requesting that a more detailed cost-benefit analysis be undertaken. We all recognize that it is very resource intensive for the staff to go through the lengthy submissions by countries. However, there is also quite a bit of burden on the authorities to provide additional information on top of the usual Article IV consultation questionnaires that they have to complete. Thus, we will have to be quite clear whether the exercise is deriving the benefits that we would like. In this regard, perhaps it would be quite useful also to get the feedback of the authorities on how they find this exercise, and I gather that the staff has drawn some general conclusions or lessons from this questionnaire. However, what I find perhaps missing is whether the staff has gone back to the authorities to provide feedback to them on any shortcomings, as that would be more useful, because otherwise it is just a one-way flow of information that results in a report and making general assessments of the state of anti-money laundering legislation in countries without really deriving the full benefit of it and providing a response back to authorities. I also note that in at least two of the countries in my constituency there was no follow-up discussion during the Article IV process with regard to the questionnaire that was provided. That could have been because of the immense amount of work that needed to be done to prepare for that.

One of the highlights of the questionnaire is, as has been pointed out, the amount of technical assistance that will be required, especially for smaller countries. I would like to echo the comments made by Mr. Varela that we should not, in trying to boost technical assistance for money laundering, do it at the expense of other technical assistance work. I would also like to emphasize that we should not lose sight of the more important and critical issues of financial sector supervision while we are focused on money laundering, and end up forgetting about other more critical issues, which I think deserve much more attention than currently.

One final point regarding the analysis by the Legal Department in the last section of the report. I really wonder about the usefulness of such an analysis, although I recognize that this was done much earlier based on information available much earlier. Nonetheless, the information provided there covers only a small sample of countries and there are numerous caveats and qualifications that the information that has been used may not be updated, and perhaps information provided in the questionnaire is more updated. Thus, I really wonder what is the usefulness of that analysis for this report, but it is a point for the staff to think about.

The Director of the Monetary and Exchange Affairs Department (Mr. Ingves), in response to questions and comments from Executive Directors, made the following statement:

There was a question in Mr. Reddy's statement about country-specific circumstances. There is a paragraph in the methodology document that clearly states that country-specific circumstances have to be taken into account. It is in the first few sections of the document. In addition, we envisage that the methodology will be used in a similar way as when we assess the Basel Core Principles and other types of assessments.

A number of speakers have asked about the questionnaire and about a cost-benefit analysis. The questionnaire came into existence because we knew about a year ago that we would not have the capacity during the year to assess a large number of countries because we did not have the staff. Thus, despite the lack of resources, we wanted to put in place a process that would increase our knowledge in a larger number of countries regarding what is actually going on, and in that sense the questionnaire has been helpful despite all the effort that has had to go into it on the side of the countries. Going forward, this will change because if approximately 50 assessments are made per year it will not take forever to assess the entire membership. We will of course examine the questionnaire once the methodology has been approved.

> On bilateral donors, we will do our best to make sure that such countries are mentioned in the report. We will also explain better the FIRST initiative.
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> When it comes to the experts and them not coming from the Fund, a number of speakers have pointed out that this needs to be looked into going forward, because we have to put in place procedures such that the experts are independent and are also independent from the Bank and the Fund because they are going to carry out work that we are not supposed to be involved in. Nevertheless, we also have to find a way of agreeing with the FATF to set up the processes in such a way that it would be acceptable for us.
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> Regarding Mr. Tombini's comments, Colombia is already included in the revised version of the paper. On law enforcement, we were talking in the paper about the Bank and the Fund, which includes the Boards.
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> With respect to the number of assessments we intend to conduct, we want to avoid overlap. As there is going to be a shortage of experts, it is in no one's interest to do the same thing twice within a short time period, and we have already started discussing this with the FATF when it comes to how to set it up. However, it is also fair to say that we have concentrated in the past months on getting the methodology completed and agreed to, and the next step after the FATF Plenary is to come up with a country and assessment list that makes sense to all of us.
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> Clearly, also going forward, many have pointed out that a special effort and special attention needs to be paid to the information sharing issues, particularly information sharing between countries, and we will certainly keep an eye on that.
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> There was also a question about what to do with the old FSAPs. Well, clearly there are some gaps there, and we basically have to find a way of going back to some of them and making sure that we, in one way or another and in a reasonable way in terms of the resources we have, add these assessments, so that ultimately all members will be included in one way or the other.

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

> Mr. Kiekens raised questions about the number of assessments we plan to do. As I mentioned in my introductory remarks, we have scheduled 15 OFCs and 19 FSAPs. So far, we have received three responses from the FATF and the FSRBs on their mutual evaluation schedules, and there are a total of

> 22 assessments identified so far by these groups. We have already identified seven of those that would overlap with our own assessments. Thus, we are presently now at the stage of discussing with the FATF and the FSRBs how to combine the assessments in order to avoid duplication. Therefore, the figure of 50 is really a projection assuming that we would be conducting on our part about 34 FSAPs and OFC assessments, but we would be utilizing in those assessments some of the mutual evaluations, and would not be conducting the detailed assessments as part of those missions. We would use the results coming from the FATF and the FSRBs to form our own mission assessments, so we would anticipate that combining our own assessments with those of the FATF and the FSRBs, about 50 detailed assessments could be conducted as part of the pilot project. As I mentioned, the actual modalities for the combining of information is still under discussion with them. The FSRBs will need to go back to their governing bodies to seek approval in terms of what will be acceptable for mutual evaluations. Therefore, we would probably within the next few months be able to come back to the Board with more specific information about what those arrangements would be.

The Acting Chair (Mr. Aninat) remarked that technical assistance for AML/CFT work would not come at the expense of traditional technical assistance activities. The issue of providing technical assistance would be discussed further with the FATF during its October Plenary. It was expected that requests for technical assistance during the early part of the pilot project could be accommodated by existing budgetary resources and aid from donor countries. However, the Board would have to decide in early 2003 the amount of technical assistance it wished to approve for AML/CFT work in the overall 2003/04 budget.

It would be important to ensure that outside experts selected to assess law enforcement issues maintained their independence, the Acting Chair noted. However, there were not as many AML/CFT experts available as there were for other areas where the Fund used outside experts. Thus, the various agencies involved—the Fund, the Bank, the FATF, the FSRBs, and the U.N.—would all have to collaborate closely to identify and select those experts.

The Director of the Monetary and Exchange Affairs Department (Mr. Ingves) commented that Mr. Chatah's suggestions to revise some of the references in the paper to the independent experts could be accepted if the Board did not object to them.

Mr. Kiekens asked whether the FATF had already started envisaging how experts in the area of law enforcement assessments would be selected, to whom they would be accountable, and how their assessments would be made consistent with one another.

The staff representative from the Monetary and Exchange Affairs Department (Mr. Johnston) replied that the Fund had already started designing a template that the assessors could use when conducting assessments. The staff was intending to meet with FATF delegates during the upcoming Plenary in order to explain to them how the ROSC process worked, as well as how the staff saw the process moving forward. The staff also intended to work with the FATF and the FSRBs to ensure that their procedures would be consistent with the ROSC process.

The Acting Chair (Mr. Aninat) remarked that the joint progress report would be revised in light of Executive Directors' comments, and would be circulated to the IMFC and published. The progress report on responses to the AML/CFT questionnaire would also be published.

3. PROLONGED USE OF FUND RESOURCES—EVALUATION—CONCLUSION

Documents: Evaluation of the Prolonged Use of Fund Resources (SM/02/287, Volume I, 9/6/02; and Volume II, 9/6/02)

Length: 25 minutes

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

> Executive Directors welcomed the inaugural report on the Evaluation of Prolonged Use of IMF Resources prepared by the Fund's Independent Evaluation Office (IEO) which was established by the Fund in 2001. The report presents a candid, comprehensive, and broad-ranging analysis which raises key issues about the Fund's approach to the prolonged use of resources by members, and makes a number of recommendations to address them. In addition the IEO report deals with several related aspects of the Fund's core activities.
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> Directors commended the prompt and favorable response to the IEO report by the Fund's Management. They agreed with Management that this report—and other projects now being undertaken by the IEO—should play a helpful role in further developing the IMF as a listening and learning institution which is willing to adapt its policies in the light of experience, in order to improve its effectiveness. Directors welcomed Management's proposal to set up a task force to prioritize the recommendations and lay out a strategy to implement them, and looked forward to following up on the recommendations early next year. The initial reactions and views of Directors, while preliminary, will certainly contribute to the work of the task force.
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> Directors noted that the report raises a number of important issues in areas that are not only relevant to prolonged use per se but also relate to key aspects of the reform agenda that the Fund has already begun to implement. Among the latter are Fund surveillance, conditionality, program design and ownership, and access policy. The results of the debate that will draw on the IEO's fresh perspectives on these areas will be folded into our future work.

Directors agreed that over time, different definitions of prolonged use have been used. They noted the definition in the IEO report, which treats a country as a prolonged user if it has been under Fund-supported programs for seven or more years in a ten-year period. On this basis there is evidence of an increase in prolonged use in recent decades in terms of the number of countries, share of the Fund's membership, and total financial exposure. Directors saw merit in the IEO's recommendation to develop a definition of prolonged use, to enable the Fund to pursue greater due diligence in these cases. Many Directors, however, noted that any definition must be carefully crafted and differentiated to take into account the specific situation of low-income countries relying on Fund-administered concessional resources. Several Directors cautioned that any effort to develop a definition should not lead to the creation of a new class of members.

Directors agreed with the IEO's finding that the increase in prolonged use has been due to a variety of systemic and country-specific factors. The growing integration of countries into an increasingly complex and more open global environment, while bringing major economic benefits and opportunities, has also in many cases made them more vulnerable to external shocks and propelled members to seek Fund resources. In addition, prolonged use reflects the evolution of the role of the Fund—particularly as regards its key responsibility in assisting low income countries. This group of countries now comprises the largest number of prolonged users, according to the definition used by the IEO. In the transition economies, the longer framework of Fund involvement has been associated with the Fund's role in supporting the transformation to a market-based economic system, which requires major structural reforms and fundamental changes in institutions.

Directors reviewed the circumstances in which long-term Fund financial involvement can be an appropriate response to help countries sustain strong macroeconomic policies and address, through structural reforms, deep-seated problems that, by their nature, require many years to resolve. Many considered that for low-income and transition economies, the key challenge is to design sound programs and to ensure their implementation on the basis of strong ownership and close monitoring, rather than to avoid prolonged use per se. For low-income countries relying on concessional financing administered by the Fund, most Directors did not consider the relatively high incidence of prolonged use analyzed in the report as necessarily indicating a problem that needs to be corrected. A few Directors, however, called for a re-assessment of the Fund's strategic role with respect to low-income countries and possible further delineation of the respective mandates of the Fund and the World Bank.

Directors also noted, however, the evidence on the association of prolonged use with economic programs that turned out to be less successful than expected. The report points to a variety of reasons, including weak implementation capacity, lack of firm ownership and commitment, or weakness in program design. In addition, concerns were expressed about a mismatch between a program's long-term objectives and the shorter-term instruments available to the Fund to help achieve these objectives, and about the moral hazard risk associated with the perception that Fund resources would be available over a long period. As a result, prolonged use can have significant adverse implications for the credibility and effectiveness of Fund-supported programs. In addition, the countries themselves may suffer if longstanding exposure to conditionality becomes a hindrance to domestic policy formulation. Several Directors also expressed concern about the financial implications of prolonged use, noting the adverse impact of prolonged use of the Fund's regular resources on the Fund's liquidity and its monetary character, and the limited availability of PRGF-resources to support low-income countries.

Directors associated themselves with the main objectives of the IEO report, which include tailoring policies to address the special situations of prolonged users and aim to eliminate the incidence of inappropriate prolonged use, while reducing its adverse consequences. Many Directors underscored that this should be seen as part of a broader effort to ensure greater effectiveness of member country programs supported by the Fund.

Directors were encouraged that some key IEO recommendations regarding streamlining of Fund conditionality, the importance of country ownership, and the need for more effective collaboration with the World Bank are already being internalized as elements of the review of Fund conditionality. They saw this as confirmation that the Fund is moving in the right direction. At the same time, the discussion highlighted that implementation of these initiatives will be an ongoing process, involving sometimes difficult judgments, in particular regarding greater selectivity in the provision of Fund financial assistance where strong country ownership is lacking, as well as the proper use of prior actions.

Directors also underscored the importance of increasing the effectiveness of Fund technical assistance in support of institutional capacity building. Regular Fund surveillance of program countries should reassess economic developments and strategy from a fresh perspective. They also saw a need for continuing effort at improving program design.

Noting the difficulty of judging ex ante whether a particular user would become a prolonged user, Directors supported the IEO recommendation that staff papers presented to the Board in support of requests for Fund financial assistance should be more transparent and candid in assessing the adequacy of institutional capacity and the degree of ownership—both essential for program success. In particular, Directors underscored the importance of also explaining clearly the downside risks surrounding a program, and of avoiding any bias toward over-optimism, including by ensuring that the program is based on realistic growth and export assumptions.

As recommended by the IEO, Directors called on the Fund management and staff to adhere more closely to the existing guidelines for dealing with prolonged use. In this context, they stressed especially the desirability of more systematic ex post assessment of cases where prolonged use occurs, with follow-up monitoring of program implementation, and where appropriate the elaboration of corrective measures as part of a conscious “exit strategy”. A number of Directors suggested that, to be useful, exit strategies should be sufficiently flexible, taking into account country-specific circumstances and incorporating policies to help countries access international capital markets and attract foreign direct investment.

Directors noted that cases of prolonged use are often related to the demand for Fund programs as a signaling device that gives a “seal of approval” to the country’s economic policies and is required by some donors and creditors. Noting that it would be desirable to develop credible alternative ways for the Fund to indicate to the outside world its approval of a member’s policies, Directors looked forward to a forthcoming discussion on the signaling function. They noted that such alternatives would need to be prepared carefully and on the basis of consultations, including with the Paris Club.

A number of IEO recommendations have implications for important aspects of internal governance, including career incentives for staff, continuity of staff missions, the role of resident missions, and the importance of providing full and timely information to the Executive Board members. These deserve careful consideration.

Directors expressed a wide array of views on whether and how staff should take account of political economy issues. One suggestion to be explored further is that staff reports should include a candid assessment of domestic social and political conditions and related potential risks to the program. Directors recognized, however, the need to proceed with caution in this area, given sensitivities relating to even the appearance of political interference by the Fund in members’ internal political affairs.

There was virtually no support for the idea of imposing a differentiated rate of charge—i.e., a higher rate of interest for prolonged users—which Directors felt would be particularly inappropriate for low-income member countries that need highly concessional assistance.

Finally, Directors commended the high quality of the IEO report and expressed their confidence that it will serve to establish the IEO’s credibility and its value to the Fund. They agreed that the report and related documents should be published, including on the IMF and IEO Web sites.

4. MEXICO—2002 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2002 Article IV Consultation (SM/02/260, 8/15/02; and Cor. 1, 9/20/02); Selected Issues (SM/02/289, 9/9/02; and Sup. 1, 9/9/02); and Report on the Observance of Standards and Codes—Fiscal Transparency Module (SM/02/277, 8/26/02)

Staff: Kalter, WHD; Kincaid, PDR

Length: 2 hours, 5 minutes

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

> The following information, which does not change the thrust of the staff appraisal, has become available since the staff report (SM/02/260) was issued to Executive Directors.
>
> Recent Economic Developments
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> Recent data confirm that economic activity rebounded strongly in the second quarter of 2002, following 6 quarters of contraction or stagnation. Real GDP grew by 1.2 percent on a seasonally adjusted basis, as exports were supported by stronger demand from the United States, and final domestic demand grew sharply (by 2.8 percent) following several quarters of weakness. Indicators for the third quarter are mixed. Both industrial production and non-oil exports were about unchanged in July (compared with the second quarter); however, employment in the formal sector grew by 1.5 percent during this period.
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> The 12-month inflation rate rose further to 5.3 percent in August 2002 (compared with the end-year target of 4.5 percent), owing to increases in administered prices. As a result, inflation expectations have risen to close to 5 percent for 2002, notwithstanding the further decline in core inflation to under 4 percent from over 5 percent in December 2001.
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> In the first half of 2002, the overall external current account deficit is estimated to have reached 2.1 percent of GDP, slightly smaller than reported in the staff report. About 90 percent of the deficit during this period was financed by net inflows of foreign direct investment.

Recent Financial Market Developments

Market sentiment towards Mexico continues to be positive. Sovereign bond spreads have narrowed from 418 basis points in mid-August to around 400 basis points (as of September 17). Mexican issuers have maintained access to international capital markets and the local corporate bond market has also remained active. Last week, the federal government issued US$1.75 billion in 20-year global bonds at a spread of 353 basis points. Most of the proceeds from the bond sale (US$1.3 billion) will be used to retire Brady bonds, while the remainder will be used to cover bond redemptions in 2003. On August 21, HSBC Holdings announced that it would acquire Bital (Mexico's fourth-largest bank) for US$1.1 billion.

The peso has depreciated to close to Mex$10 per U.S. dollar from Mex$9.8 per U.S. dollar at end-July, while domestic interest rates have declined slightly to below 7 percent. Gross international reserves have been stable (at approximately US$47 billion).

Policy Initiatives

In mid-August, the government sent to congress its proposal for electricity reform, which aims at modernizing the sector and increasing capacity. It involves allowing the full participation of the private sector in electricity generation, and enabling private generators to sell electricity to large (normally corporate) consumers. These changes would entail amending two constitutional articles, which reserve for the public sector the right to sell and generate electricity.

As of September 26, banks will be required to establish at the Bank of Mexico (BOM) a compulsory deposit for an indefinite period of Mex$150 billion for the system. The distribution of compulsory deposits among individual banks will be determined on the basis of peso-denominated liabilities. Most of this amount (Mex$95 billion) will replace already existing deposits at the BOM, not all of which are compulsory. The new deposits will carry a lower interest rate than the ones being replaced. The authorities have indicated that this action does not change their monetary policy stance, as any net reduction in liquidity will be channeled back in full to the money market on a daily basis through the BOM's open market operations. Rather, it is intended to reduce the BOM's interest costs (strengthening its net income position while lowering that of the commercial banks) and to improve its capacity to conduct monetary policy (as the higher level of compulsory deposits will enable the BOM to maintain a daily net creditor position with the money market with less reliance on open market operations).

Sustainability Analysis

As noted in the staff report, the sustainability analysis presented in Appendix Box 6 was based on the preliminary methodology proposed in "Assessing Sustainability" (SM/02/166) presented to the Executive Board on June 14, 2002. However, simulating shocks to domestic nominal interest rates for countries such as Mexico, that have experienced significant disinflation in recent years overstates interest rate movements associated with a two-standard deviation increase compared with a comparable shock to domestic real interest rates. Accordingly, the analysis was modified to examine the implications of a two-standard deviation shock to domestic real interest rates (Supplement 1 of the Selected Issues Paper, SM/02/289).

The results show a much smaller increase in the public sector debt-to-GDP ratio than the one presented in Appendix Box 6; the profile of the external debt-to-GDP ratio is unchanged. In the revised simulations (see Supplement 1), the public sector debt peaks at less than 53 percent of GDP in 2003 (following a two-standard deviation increase in domestic real interest rates and a decline in real GDP growth). This compares with a peak of close to 70 percent in the simulations presented in the staff report, which were based on a two-standard deviation increase in nominal interest rates.

Mr. Oyarzábal and Mr. Beauregard submitted the following statement:

An orderly adjustment of economic activity: Last year, in my statement for the 2001 Article IV Consultation on Mexico, I stressed the fact that for the first time in the last three decades Mexico experienced a smooth change of political power that was not characterized by a deep economic and financial crisis. In this opportunity, I would like to point out the fact that for the first time in many years, the marked slowdown in economic activity in 2001 took place in an orderly manner as a result of my authorities' timely and appropriate policy response to the changing economic environment.

New challenges emerged soon after we last met. The sharp slowdown in world economic activity in 2001, particularly in the United States, and the uncertainty that prevailed after the terrorist attacks on September 11, had a negative impact on Mexico's economic activity. After growing 6.6 percent in 2000, last year's GDP contracted 0.3 percent. This result in the real economy, and both the Federal Government's fiscal discipline and Banco de México's prudent monetary policy, led to a significant reduction in the inflation rate to 4.4 percent (the official target was to achieve an inflation rate not greater than 6.5 percent). As a result, nominal and real interest rates declined and the peso remained stable.

Public sector finances were negatively affected by the economic slowdown, the strength of the peso and the fall in international oil prices.

Nevertheless, decisive and timely actions were key to reach the fiscal deficit target set for the year. On a cyclically adjusted basis, public finances recorded one of the most important adjustments in recent years. I would like to emphasize that these efforts have been pursued while protecting the allocation of resources to social sectors, like education and health. In particular, expenditures in social programs increased 6.1 percent in real terms during 2001.

On the external front, the deficit in the current account remained stable (2.8 percent of GDP). This deficit was financed totally with long-term external resources, particularly Foreign Direct Investment (FDI). The surplus in the capital account was 22.7 billion U.S. dollars, of which FDI flows were 24.7 billion U.S. dollars, 1.4 times the deficit in the current account. Net international reserves increased by 7.3 billion U.S. dollars and the ratio of gross official reserves to short-term debt by residual maturity increased from 86.8 percent in 2000 to 122.4 percent at the end of 2001.

In sum, economic policies in Mexico were geared at maintaining economic stability and adjusting to the new economic conditions. Importantly, even during this difficult year, my authorities were able to further reduce Mexico's vulnerabilities. As a result, two of the leading rating agencies (Standard & Poor's and Fitch IBCA) upgraded Mexico's external sovereign debt rating to investment grade at the beginning of 2002 and Moody's, which upgraded Mexico to investment grade in March of 2000, improved the country's rating one additional notch. These upgrades have made Mexico more resilient to external shocks by diversifying the type of investors willing to invest in the country.

2002 continues to be a challenging year. Even though there were signs of a solid recovery in the world economy during the first quarter of 2002, it is now clear that it will not be as strong as initially expected. This year has also been characterized by an increase in investor's risk aversion. Despite this negative environment, the economic performance of Mexico has been satisfactory. Although economic growth during the first quarter was still affected by last year's economic slowdown, GDP growth during the second quarter showed clear signs of recovery (2.1 percent compared to the same period of last year). In addition, other indicators, like the global index of economic activity, industrial production, the level of both private investment and consumption, and the labor market, have been also confirming that the economic recovery is under way. This being said, it is important to recognize that Mexico's economic growth in the months ahead will be greatly influenced by the international environment, especially the economic recovery in the United States, our main trade partner.

Monetary policy has been managed prudently to achieve an annual inflation rate not greater than 4.5 percent. The monetary stance was tightened in February to prevent contagion to other prices and wage negotiations of the increase in some public sector prices that took place in January and February and that would have jeopardized the attainment of the inflation objective. The positive results of the new monetary stance on inflation expectations allowed Banco de México to relax monetary policy in April. I would like to emphasize that this latter change was not driven, as some analysts have pointed out, by concerns regarding the strength of the peso. The Board of Governors remains committed to the inflation-targeting regime in place and they are clearly aware that the central bank, having only one instrument to conduct monetary policy, can achieve only one objective. Targeting other variables, such as the output gap or the level of the exchange rate, would only undermine the credibility Banco de México has gained in recent years, placing at risk the nominal anchor of the economy. My authorities remain committed to take further action if needed to achieve the inflation target set for 2002.

On the fiscal front, the Federal Government has again confronted a difficult environment. Lower public sector revenues than programmed made it necessary to cut public expenditures in April. In parallel, important efforts have been made in order to promote a more efficient use of resources and an increase in savings in the Executive branch. Public debt management has continued to be geared at extending the maturity profile and lowering the cost of the public sector debt.

I also would like to stress that even though public sector revenues have been lower than programmed, they have improved compared to last year's. As of July, tax revenues have increased 9.4 percent in real terms compared to the same period in 2001. This result was achieved despite almost nil economic growth during the first half of the year, which highlights my authorities´ efforts to broaden the tax base and to increase tax compliance. Income-tax revenues during the first seven months of this year increased 11.3 percent in real terms as a result of the reforms approved by Congress last year, while VAT revenues were lower 2.6 percent in real terms compared to the same period in 2001.

Looking ahead, the increase in international oil prices, the lower cost of the public sector debt and the savings that the administration has been able to secure do not make it necessary to cut public expenditures again in order to achieve the fiscal deficit target set for the year. This being said, I want to stress that my authorities remain fully committed to continue working in advancing the fiscal consolidation process. We recognize that tax administration cannot be a substitute for a more fundamental strengthening of non-oil revenues, but it constitutes an integral part of the overall strategy to make public finances more efficient.

On the external front, despite the uncertain international economic environment that has prevailed, the results are encouraging. Importantly, Mexico's access to international capital markets was not hindered by the higher volatility in international financial markets. Proof of this are the very successful issuances of 10- and 30-year bonds in international markets late last year and in January 2002, and last Tuesday's issuance of a 20-year bond. The deficit in the current account (2.1 percent of GDP in the first half of the year) continues to be financed through long-term capital sources, mainly FDI (90 percent). Net international reserves continue increasing, reaching a record level of 47 billion U.S. dollars as of last Friday.

Despite the real appreciation of the peso that has taken place in recent years, the current account deficit has remained stable and consistent with the availability of long-term external resources. Besides, the share of Mexican exports in the U.S. market has continued to increase, as noted by staff in Figure 14. Furthermore, the equilibrium real exchange rate could be expected to appreciate as per capita income and openness increase, as has been the case in Mexico in recent years. Nevertheless, the recent depreciation of the nominal exchange rate should ease some concerns regarding the level of the real exchange rate. What is important to highlight is that in the context of an economy with a flexible exchange rate regime, and the absence of both large balance of payment imbalances and large inflows of short-term capital, the adjustment has taken place in an orderly manner, with limited impact on domestic interest rates.

On remaining vulnerabilities and specific issues, the staff points out some remaining vulnerabilities in the Mexican economy. At the outset, I would like to stress that my authorities remain committed to continue working to further reduce them, but at the same time it is important to emphasize the progress that has been achieved so far.

On Mexico's gross external financing requirements, I would like to highlight that the figures reported by staff for 2002 and 2003 include a very important change compared to the figures for last year. In particular, debt amortization was reduced from 51 billion U.S. dollars in 2001 to 37 billion in 2002 and 39 billion in 2003. These changes reflect my authority's efforts in order to improve the amortization profile of the external debt. This strategy has proved to be very successful and they will continue implementing it in the future. Just last Tuesday Mexico issued a 20-year global bond in international markets as part of this strategy. On the other hand, the flexible exchange rate regime in place ensures that the deficit in the current account will be driven mainly by the availability of long-term external resources. Thus, if capital inflows were to be reduced, the exchange rate regime in place ensures the adjustment of the current account deficit to a level consistent with the new availability of external long-term capital. Most importantly, staff's own analysis shows that gross external financing requirements are not really a source of vulnerability. Paragraph 40 of the staff report explains how a crisis like the one experienced by Mexico in 1995 and similar contagion effects like the ones felt from the crises in Russia (1998) and Brazil (1999) could be handled very well today. Having said this, it is important to highlight that there have been very important changes in the Mexican economy in recent years. Thus, replicating those crises today would constitute a very large shock whose probability of occurrence is rather low.

With regard to the gross financing needs of the public sector and its exposure to both rollover domestic debt and an increase in peso denominated interest rates, my authorities would like to make it clear that they are fully aware of said risks and that important efforts have been made in recent years to improve the profile of the public sector domestic debt. For example, at the beginning of the Fox administration the maturity of the government's domestic debt was 538 days and as of June 2002 it has risen to 793 days. To this end, my authorities have been developing a long-term peso yield curve by issuing, since last year, ten-year fixed-rate bonds, which is complementing the issuance of three- and five-year fixed-rate bonds initiated in 2000. And as of this year, seven-year fixed-rate bonds are also being issued on a regular basis. This being said, I would like to emphasize that these developments cannot be achieved overnight. The issuance of long-term instruments brings about new financial risks to investors that call for a cautious approach to the pace at which these developments take place. On the other hand, market conditions also play a key role in determining the speed of introduction of these developments. Finally, a proactive liability management strategy continues to render good results in extending the maturity profile of the public sector external debt and in reducing its cost.

Staff also points out the high level of foreign debt of the Mexican corporate sector. However, we would like to emphasize that the level of indebtedness of the private sector in foreign currency does not pose a systemic risk to the economy. First, most of the companies that show high levels of foreign debt are exporting firms that generate their cash flows in foreign currency. This certainly limits the exchange rate risk of the non-financial corporate sector. Second, the reduction in domestic interest rates, the existence of a long-term yield curve developed through the issuance of public debt, the more important role of Mexican institutional investors as providers of long-term resources in pesos, and the introduction of a new type of debt instruments, called "certificados bursátiles", have allowed many of these companies to substitute debt instruments denominated in pesos for foreign debt. Since last year, when these certificates were introduced to the market, there have been issues of an equivalent of 4 billion U.S. dollars, and there is authorization to issue an equivalent of 3 billion U.S. dollar more. Third, although bank credit to the private sector has not yet been resumed due to both demand and supply factors, my authorities remain confident that the financial reform and changes to the Mexican legislation will help in promoting a substitution of peso liabilities for foreign debt.

During the past few years my authorities have made important progress in raising their surveillance activity to the Mexican corporate sector. For example, the coverage of the sample used by my authorities to monitor developments in this sector represents approximately 70 percent of the total private debt in foreign currency. Hence, their point of view is that the coverage of this sample is sufficient to appropriately assess the risks of this sector. But, as always, if at some point in time a broader coverage is needed, they will work to expand it.

Staff suggests that banking supervision should be further strengthened reducing the fragmentation of supervisory powers and that the Credibility of the National Banking and Securities Commission (CNBV) needs to be fostered. On the first point, I would like to point out that there is not an optimal model in the world for the structure of banking supervision. Some countries have a single supervisory institution while others have a decentralized framework. In our view, what it is important in this regard is that there should be close coordination among the regulatory authorities, which is the case in Mexico, although there is always room for improvement. On the second point, throughout the recent years, the CNBV has strengthened significantly its credibility.

Once again, my authorities would like to express their strong disagreement with the comparison made by the staff regarding the borrowing pattern from international banks between Mexico and Brazil. To suggest that the Mexican corporate sector is particularly vulnerable to a potential sharp retrenchment of international bank lending after looking at only one single indicator is misleading. Besides, this comparison is of limited value added because the staff, in a more complete analysis, concludes that the Mexican corporate sector is overall in good financial health and that a widespread solvency problem is unlikely. A cross-country comparison should take into account that there exist strong differences not only between the corporate sectors of the two economies, but also between the two economies themselves. We also need to highlight that said index for Mexico and Chile, and Mexico and Taiwan Province of China, is also high, a comparison that is not made in the report.

Banco de México's long-term inflation objective and the "corto":

Banco de México formally adopted an inflation-targeting framework in 2001 and announced its annual inflation objective up to 2003. Consistent with this framework, the central bank announced last July the inflation objective that will guide its monetary policy actions in the long-term, beginning in 2004. The objective was set at 3 percent with an interval of plus/minus one percentage point around the long-term goal. It is important to underline that the interval is not an indifference or tolerance margin. Rather, it is the recognition that exogenous factors beyond the control of the authorities have unpredictable effects on headline inflation.

The Consumer Price Index—the broader price index in Mexico to measure inflation—will be the reference price index. However, the Board of Governors stated that they are going to permanently assess the evolution of core inflation as an important indicator of inflationary pressures in the medium term. Last, but not least, if significant deviations from the long-term target arise, Banco de México will publicly explain their causes, its view on the future evolution of the inflation rate and the monetary policy actions that it will implement to return to an inflation path consistent with the long-term objective.

One more time, staff stresses that a policy of directly targeting interest rates would strengthen Mexico's monetary policy framework because it is an element of a more formalized inflation targeting scheme. Although I do not deny that such a change could enhance transparency, at the same time it is important to highlight that the "corto" has worked very well, something that staff recognizes in their report. In addition, the benefits of enhanced transparency need to be weighed against the costs of moving to the proposed policy. In particular, a system that targets interest rates would increase the exchange rate volatility, and this needs to be taken into account in the context of an open economy subject to sizable external shocks like in the case of Mexico. As I said last year, my authorities have analyzed other monetary policy instruments but they have not found a superior alternative. Once they are convinced they have found one, they will substitute the "corto".

The National Program to Finance Development 2002–2006 (PRONAFIDE): In June, President Fox unveiled the PRONAFIDE, which is the medium-term strategy that will seek to create new and strengthen current domestic sources of financing within a stable macroeconomic environment. The objectives of this program are the following: consolidate a stable macroeconomic environment; reduce the absorption of financial resources from the government in order to promote private investment; facilitate the conditions for job creation in the private sector in order to match the number of jobs required by the dynamics of the population; expand the potential rate of economic growth, and generate the resources needed to finance the social programs set forth in the National Development Plan 2001–2006.

In order to achieve these objectives the program features the following five strategies:

Implementation of structural reforms: My authorities remain committed to continue working with Congress in order to get approval for important structural reforms. In this regard, President Fox submitted to Congress last August a proposal to reform the electricity sector. The Ministry of Labor is leading an open dialogue with private sector representatives and union leaders in order to advance the reform to the Federal Labor Law. Congress is reviewing a proposal sent by the Executive branch to reform the budgetary process. Congress prepared a proposal to reform the Federal Law of Telecommunications that is under discussion. In the financial area, Congress has just recently approved reforms to the law of private pension funds and is currently discussing changes to the Mexican legislation that seek to strengthen the framework under which commercial banks will provide credit in the economy (Ley de Garantías y Concursos Mercantiles).

A gradual and sustained increase in public sector savings: Advancing in the fiscal consolidation process is key to further reduce the absorption of financial resources by the government.

Increase in private domestic savings: One key challenge is to increase private savings in order to finance private sector investments. In this regard, it is worth emphasizing that considerable progress has been achieved so far in increasing the availability of long-term domestic savings that resulted from the reform to the pension system for private sector workers some years ago. The development of the local bond market is also playing a key role in this regard.

External savings will play a complementary role to domestic savings: The aim is that domestic savings will be the main source of financing in the economy, though external resources, mainly FDI, will play a complementary role. Further advancing in the implementation of the structural reform agenda and in the consolidation of a stable macroeconomic environment are key elements to continue attracting long-term resources.

Role of the financial sector: The financial sector was one of the most affected by the crisis in 1995. Since then, important progress has been achieved in strengthening its legal, operational, supervisory and regulatory framework. In particular, since last year important changes have taken place and staff have made a good recollection of them in this and last year's staff reports.

To conclude, my authorities' reform efforts and their prudent macroeconomic management are yielding good results. Mexico's economy is now more resilient and the decoupling of the country from recent crises in some emerging market economies is clear evidence that these efforts are paying off. But there is no room for complacency. Important challenges remain. Reducing poverty levels and improving income distribution being some of them. These problems demand prompt and durable solutions. At the same time, we realize that our goals in this regard will simply not be achieved if we cannot consolidate the macroeconomic stability that has been present in recent years. This is the main task at hand.

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

Mexico's prudent economic policy management in recent years has contributed to an improvement in a number of fundamentals, including visible accomplishments particularly in strengthened actions in institutional reforms. Over the last few years, the overall fiscal deficit was almost halved, while the budget institutions and practices have been considerably improved. In addition, external public debt continued its marked decline, inflation has been reduced to below targeted levels, and growth was buoyant until 2001. This improvement in fundamentals contributed to a positive market perception of Mexico as reflected in the upgrading of its ratings and the relatively narrow spreads on its external borrowing. More importantly, the country appears to have stood out as a safe haven in emerging markets, and has not been subject to serious contagion from the regional financial crisis. As illustrated in Mr. Beauregard's informative preliminary statement and the well-written staff report, Mexico's economic outlook in the near and medium terms appears favorable. However, some important challenges remain, namely the need to (i) maintain an appropriate policy mix that strikes a balance between supporting a recovery and consolidating the stabilization gains—developments in the U.S. economy could be a major determinant of the appropriate policy mix, (ii) make progress in structural reforms in order to enhance growth prospects and reduce poverty—this is also particularly important for the medium-term fiscal consolidation strategy where policy based revenue enhancing measures are in order, and (iii) address remaining weaknesses and risks in order to further increase the economy's resilience to adverse shocks. Our comments will focus on these challenges.

The Macroeconomic Policy Mix

The overall fiscal deficit was virtually unchanged in 2001 compared to a year earlier. However, on a cyclically adjusted basis, the fiscal stance was tightened, while monetary policy was relaxed, contributing to a significant reduction in interest rates. This measured re-balancing of the policy mix appears appropriate given the marked decline in inflation and the sharp weakening of economic activity which was triggered by the slowdown in the US. For the period ahead, the authorities' development plan envisages a steady reduction of the overall deficit to about 2 percent of GDP by 2006. Faced with uncertainty about economic recovery in the United States and the weak consumer and investor confidence due to the regional crisis, the authorities appropriately decided to keep the fiscal stance unchanged in 2002.

While we fully agree with this strategy, we urge the authorities to redouble their effort to facilitate the attainment of the fiscal consolidation planned for the medium-term in order to further improve the debt dynamics which could also be adversely affected by increasing interest rates, and to enhance confidence and increase the resilience of the economy. In this connection, we encourage the authorities to increase revenue through further tax reforms in addition to the implementation of the planned measures to strengthen tax collection. The later action alone may not achieve the desired target on a sustainable basis. We are assured by the authorities' commitment to reduce expenditure in case these reforms are not passed, in order to achieve the overall fiscal targets. In reducing expenditure, a continued focus on cutting non-productive outlays, building on the country's good track record, would be necessary. In this connection, it is impressive to note that public savings increased by more than 4 percent of GDP over the last few years mainly due to a combination of an improvement in non-oil revenue and an enhancement of the expenditure structure. Further progress in this direction is important, particularly since public savings remain at a low level of less than one percent of GDP despite the recent improvements.

While the staff concludes that it would be appropriate to begin the process of fiscal consolidation in 2003, we are of the view that such action should be viewed with caution. The close link between the Mexican and the U.S. economies would, in our view, suggest that should the weakness in the U.S. economy accelerate, a tighter fiscal stance would not be appropriate.

Concerned with increased inflation expectations and continued adverse market conditions, the authorities appear to be contemplating a tightening of the monetary stance sometime soon. In view of the currently low core inflation, the sizable output gap, and the uncertainties regarding the timing and magnitude of economic recovery, we join staff in cautioning against a premature monetary tightening.

As regards the exchange rate, the relaxation of monetary policy in 2001 has facilitated a moderate depreciation of the peso. While this has only partly offset the real effective appreciation in recent years, external competitiveness appears adequate in view of the generally healthy non-oil exports growth and the increase in Mexico's market share. Efforts to further enhance competitiveness should focus on structural reforms, especially since targeting a particular level of the exchange rate would be inconsistent with the inflation targeting monetary policy framework.

Structural Reforms

The authorities' medium-term economic program envisages two alternative growth scenarios. The higher growth scenario is contingent on the passage by Congress of more comprehensive structural reforms. We hope that this will be possible, especially that a high growth rate would further improve debt dynamics and facilitate a faster reduction in unemployment, the widespread poverty, and regional disparities. In particular, it would be important to improve labor market flexibility, and reform the judicial system. Liberalizing the telecommunication sector and reforming the energy sector to attract more investment and increase capacity would also go a long way in enhancing growth prospects.

Remaining Vulnerabilities

While Mexico's debt indicators have improved significantly over the past years, both the external financing requirement and the public sector borrowing requirement remain sizable. In addition, the public sector appears particularly vulnerable to an increase in interest rates, and the corporate sector could seriously suffer from a sharp retrenchment of international bank lending. It is somewhat reassuring that the stress simulations and sensitivity analyses conducted by staff indicate a generally reasonable degree of resilience, and that only a sharp deterioration in the economic environment would seriously affect the country. That should not be ruled out. Therefore, the authorities are encouraged to consolidate the progress achieved thus far in reducing vulnerabilities in order to minimize the downside risks. In particular, it would be important to further lengthen borrowing maturities and increase the share of fixed rate instruments in order to improve the structure of public debt. In addition, establishing benchmark issues would help provide a reference to private sector domestic borrowing. The planned World Bank-led ROSC on corporate governance would also help identify areas for improvements in order to increase the resilience of the sector which could also contribute to downward pressures on interest rates.

It is encouraging that both the 2001 FSAP and this Article IV mission have concluded that the financial system's health and its resilience to shocks have continued to improve. The authorities appear determined to address remaining weaknesses, and have established a committee to follow up on the FSAP recommendations. A series of measures are being introduced to modernize the state-owned development banks and improve the legislation governing secured lending and collection on loan collateral. In addition to these measures, it would also be important to further strengthen bank supervision by reducing the fragmentation of supervisory powers and enhancing the autonomy of the banking and securities commission.

In conclusion, by pursuing prudent macroeconomic policy and reducing its external vulnerabilities since the mid-1990s, Mexico has been able to limit contagion from the regional crisis. However, this crisis, especially the situation in Brazil, as well as the slowdown in the United States, have led to a sharp decline in economic activity in Mexico. Continued skillful management of the macroeconomic policy stance, and progress in structural reforms and in further reducing vulnerabilities are essential for Mexico to remain an emerging market safe haven and for speeding up the recovery, thereby reducing unemployment, poverty, and regional disparity. We wish the authorities success in achieving these objectives.

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

Key Points

Prospects for the Mexican economy are generally favorable thanks to prudent fiscal and monetary policy as well as the implementation of structural reform; the authorities need to remain vigilant, however, given that Mexico is highly dependent on the U.S. economy and the prospects for the U.S. economy are somewhat less robust.

The authorities need to take drastic measures to reduce their heavy reliance on external financing.

The authorities are already facing the necessity of further tax reform. We urge them to examine ways to strengthen tax administration and achieve a fairer and more efficient tax system.

We commend the monetary authorities' intention to formalize a new inflation targeting framework.

The biggest challenge for financial sector reform is how to revive the domestic banks' role as a financial intermediary. We urge staff to make a deeper analysis on this issue.

Introduction

Owing to the slowdown of the U.S. economy and the decline in oil prices, Mexico's growth turned negative in 2001, for the first time since the Tequila crisis. Although there have been some signs of economic recovery in the second half of 2002, the pace of recovery has been sluggish. Even so, the market realizes that Mexico has moved toward closer economic integration with the U.S. and feels confident that Mexico has succeeded in reducing its external vulnerability by improving the external debt management—so much so that Mexico's sovereign debt rating has been raised to "investment grade." While the strong performance of the U.S. economy in the late 1990s has indeed been the moving power in the Mexican economy, it would be unfair not to commend the authorities' pursuit of a prudent fiscal and monetary policy and their efforts on the structural reform front—all of which are likely to bear fruit. The recent increase in oil prices is expected to contribute to improving both external and fiscal balances; however, the authorities need to be vigilant given that Mexico has been highly dependent on the U.S. economy in recent years and the prospects for the United States are somewhat less robust. This dependence constitutes one of the biggest risks to the Mexican economy. We hope that the authorities will not loosen their prudent fiscal and monetary stance and that they will maintain the structural reform momentum.

External Balance

Exports have continued to decline since last year; however, Mexico has firmly established itself as a base for exports to the United States, and it is expected to be well established as a base for exports to other Latin Americans countries if the FTAA comes into effect as expected by 2005. While exports are projected to increase in the medium term, an increase in exports will not necessarily lead to a favorable current account balance owing to the fact that the development of small- and medium-size industry has lagged behind, and exports rely heavily on goods produced abroad. The staff's medium-term projection for the current account indicates a widening deficit after 2003, reflecting the above-mentioned phenomenon. As staff note, current account deficits up to now have been financed by strong FDI; however, the authorities should be aware that there is a risk that FDI will be reduced, depending on exchange rate developments. They also need to be cautious about the following risks, as staff pointed out: Mexico's sizable external financing requirements; the vulnerability of public debt to an increase in interest rates: although the authorities were successful in prolonging the maturities of external debt and reducing the rollover costs, they have shifted significantly toward issuing domestic bonds with floating interest rates and short-term maturities; corporate sector lending is highly concentrated in several international banks, which are likely to sharply retrench in the event of a crisis.

Against this background, the authorities need to make a concerted effort to avoid the vulnerabilities associated with these risks by accumulating international reserves, strengthening public debt management, and developing domestic bond markets. In particular, they need to take drastic measures to reduce heavy reliance on external financing.

Fiscal Policy

The authorities have introduced since the 1980s a number of fiscal measures aimed at achieving fiscal balance. These were so successful that in recent years Mexico has been able to maintain a primary surplus. The authorities set fiscal adjustment targets, laid out in the PRONAFIDE, which aim at achieving total fiscal balance between 2002 and 2006 and reducing total gross public sector debt by about 6 percentage points of GDP over the next five years to 43 percent. The authorities will need to make more frontloaded fiscal adjustments, especially in 2003, in order to achieve these ambitious targets under the PRONAFIDE. Mexico has fundamental structural weakness on the revenue side in that oil-related revenues account for about one third of total revenues, resulting in an increase of vulnerability related to oil price volatility; and the ratio of tax revenues to GDP in the federal government is only around 11 percent, which is low compared to other countries in the region. Moreover, some have pointed out that the authorities have implemented fiscal adjustment by focusing primarily on expenditure cuts and cutting back more than expected on infrastructure investment, which has undoubtedly led to a bottleneck in economic development. Given the structural weakness on the revenue side, while the authorities need to make the necessary adjustment on the expenditure side, including by reviewing expenditure rigidity and by examining possible social security systems such as a pension system, they need to make a more concerted effort concerning revenue enhancing measures. In order to stabilize fiscal resources, tax reform is particularly crucial. The new tax measures which have been executed since February 2002 after twists and turns in the congressional debate do not include broadening the VAT base, and some doubt how much these measures will contribute to increasing revenue; indeed, half of the expected revenue is not expected to materialize. Against this background, the authorities are already facing the necessity of further tax reform, and we urge them to examine as soon as possible measures to strengthen tax administration and achieve a fairer and more efficient tax system.

Monetary Policy

Thanks to the authorities' prudent monetary policy, relatively favorable economic conditions have been maintained, domestic interest rates have been reduced along with the containment of inflation, the exchange rare has been stable supported by capital inflows including strong FDI, and there has been a substantial accumulation of international reserves. The authorities argue that there appears to be little room for easing monetary policy further under current conditions in view of the recent pick-up in inflation expectations and the international market turbulence. The authorities need to be cautious, however, about further monetary tightening given the low-core inflation, sizable output gap, and uncertainties on the timing and magnitude of the economic recovery, in part because the prospects for the U.S. economy are now moderate. We do not see any merit in further monetary tightening since it is likely to hamper economic recovery, and we fully share the staff's view that maintaining an easy monetary stance is appropriate for the time being. Nevertheless, we commend the monetary authorities' intention to formalize further the inflation targeting framework, including the announced adoption of a long-term inflation objective for 2004 and beyond and the introduction of pre-established dates for the meetings of the Bank of Mexico. We find these steps appropriate from the standpoint of enhancing the transparency of monetary policy and achieving accountability. We broadly agree with staff's proposal on adopting direct targeting of short-term interest rates as a monetary policy target instead of the current policy instrument, "corto". This has proven to be a useful policy instrument: it gives the public clear guidance on monetary policy and it is well known and accepted by the market. However, shifting to more direct targeting of short-term interest rates is better from the standpoint of presenting policy makers' monetary stance directly to the public. Nevertheless, even if the change in target is confirmed, the authorities need to fully explain both the background and the reasons for the change in order to prevent market participants' confusion.

Banking Sector Reform

After the Tequila crisis the authorities deregulated the financial sector, facilitating foreign capital participation. Moreover, the authorities have maintained and strengthened prudential regulations as well as the supervisory framework and financial indicators have improved significantly. As the 2001 FSSA reports concluded, the financial system has improved its resilience to shocks in recent years and is not likely to pose systemic problems, and the authorities so far have succeeded in stabilizing the overall financial system. The biggest remaining challenge is how to resume bank credit to the private sector, and how to revive the domestic banks' role as financial intermediaries. The selected issues paper elaborates on this issue, mentioning that outstanding bank credit to the private sector has been decreased in real terms and the role of domestic banks as financial intermediaries has been significantly reduced. On one hand, private firms' financing sources are mainly suppliers' of credit, foreign banks and other firms of the same group, and they are not necessarily facing a credit crunch problem so far. On the other hand, as the recent experience in Brazil shows, relying too heavily on external financing increases external vulnerability, and there is a high risk that these financing resources would shut down in the event of crisis. Moreover, revitalizing the financial intermediary role of domestic banks is crucial in order to stabilize the financial system. That said, we believe that the authorities need to improve credit infrastructure, including the judicial system, to ensure credit rights, commercial registration and the debt information system as well as to achieve sustainable economic growth in order to strengthen domestic banks' intermediary role. We understand that the selected issue paper elaborates on this issue to some extent, but we would welcome more staff analysis on why significant bank credit has not materialized and on possible corrective measures.

With these remarks, we wish the authorities the best in addressing the key challenges ahead.

Mr. Lushin and Mr. Lissovolik submitted the following statement:

Mexico's prudent economic policies have enabled the country to weather adverse external developments, with the economy now set to recover in 2002–2003. Both structural and macroeconomic vulnerabilities have been contained or significantly reduced as a result of fiscal reforms, prudent debt management and progress in structural reforms. This was reflected in the upgrades of foreign-currency denominated bonds to investment grade early this year as well as the successful placement of a 20-year bond more recently.

Notwithstanding the progress attained thus far, Mexico continues to face the challenge of reducing its external vulnerability to oil price volatility, as well as the need to further lower the stock of external debt. In the socio-economic sphere, poverty reduction, education, as well as the need to bridle the shadow economy remain crucial for broadening the popular support for further economic reforms.

The fiscal sphere continues to be an area, in which reforms are particularly important, given the high dependency of the country on oil revenues and the overriding need to observe fiscal prudence with the view of further reducing the country's stock of public debt. Mexico's recent fiscal reforms are an important step in addressing some of the revenue weaknesses, though we agree with the staff that further measures should aim at reducing exemptions, extending the tax base and thereby raising the revenue intake from the non-oil sector of Mexico's economy. In terms of the qualitative composition of fiscal expenditures, the rise in expenditures on social programs in real terms in 2001, alluded to in Mr. Beauregard's preliminary statement, is welcome and conducive to further advances in raising health and educational standards.

We strongly welcome the completion of the fiscal ROSC, which has elicited considerable progress in Mexico's fiscal management, while also uncovering some gaps and weaknesses in the regulatory framework. We note in particular, the emphasis placed on transparency (most notably with respect to the publication of costs associated with quasi-fiscal operations) and the presentation of fiscal information. We believe that addressing these weak spots in the fiscal regulatory framework will enable Mexico to reap sizeable dividends both on the revenue and on the expenditure side of the budget. The results of the fiscal ROSC may also go some way towards informing the debate within the country and ushering in a political consensus within the Mexican society on the future evolution of fiscal reforms.

On monetary and exchange rate policy, given the need to reduce the budget deficit, while at the same time pursuing policies that are conducive to economic recovery and a reduction in the debt burden, we agree with the staff that the monetary stance should not be overly restrictive. With respect to the changes to the inflation-targeting arrangement proposed by the staff, like Mr. Beauregard, we believe that these should be evaluated in terms of the relative costs and benefits. In this respect, while there are clearly benefits stemming from the improved transparency of the arrangement through direct targeting of interest rates, we also believe that the costs of higher exchange rate volatility may be notable, particularly in view of the likely increase in the exchange-rate pass-through to prices as output recovers in the economy.

In the financial sphere, we welcome the steps undertaken by the Mexican authorities to address some of the financial vulnerabilities in line with FSSA's recommendations. The key challenge will reside in further safeguarding the soundness of the financial sector, while at the same time gradually re-incorporating it into the intermediation mechanism of the country's economy. In the corporate domain, we tend to agree with Mr. Beauregard that the comparison between Mexico and Brazil regarding the vulnerability to potential retrenchment of international bank lending is somewhat misplaced. Indeed, as argued by Mr. Beauregard and by the Fund itself in the most recent WEO report (essay on corporate performance in the global economy), there is a considerable number of factors that explain differences in corporate vulnerabilities across countries, which in turn include institutional factors, macroeconomic and sector- and firm-specific factors. If all of them are taken into account, the parallels between the profiles of corporate vulnerabilities in Brazil and Mexico become significantly more questionable. Accordingly, while the analytical value-added of such sweeping comparisons is hardly significant, their effects on market sentiment could well have a palpable negative effect. We strongly welcome a World Bank-led ROSC on corporate governance, which could shed some light on ways of raising corporate governance standards and thereby transparency and overall stability.

On the external sector, while we recognize the benefits of regional trade liberalization undertaken by Mexico that are now expected to be further expanded through bi-lateral agreements with trading partners in Europe, South America and Asia, we would like to emphasize the relative benefits of multilateral trade liberalization. The latter are by now proven both empirically and theoretically to be superior to the benefits stemming from "selective liberalization" within trading blocks. Furthermore, the fact that the average import tariff rate in Mexico has increased since 1997 by 3 percentage points to 16.5 percent does not suggest that multilateralism and regionalism are invariably complementary instruments in the advancement of Mexico's trade liberalization.

In conclusion, we note that the extensive analysis of the economic sustainability of Mexico's economic development undertaken by the staff has revealed substantial resilience to adverse external shocks. Importantly, this achievement has been attained through greater liberalization of the economy both in the trade and in the financial sphere. Further progress in economic development will be a function of the success in mitigating external vulnerabilities, while at the same time forging ahead with structural reforms in key sectors of the economy. Building the institutional framework of the market economy, particularly through upgrading the country's social safety net, is key for attaining popular support for reforms and for attenuating the competitive pressures associated with Mexico's rapid incorporation into global economy. We wish Mexican authorities every success in meeting these challenges.

Mr. Guinigundo and Mr. di Maio submitted the following statement:

Key Points

Skillful economic management and past progress on financial and institutional reform have paid off for Mexico.

A central aspect of the Mexican experience has been the translation of economic growth into a marked reduction in poverty, although lowering poverty will remain an ongoing challenge.

Fiscal consolidation should be the number one priority to stabilize debt and free savings for private investment, as well as providing the needed flexibility for the full operation of the automatic stabilizers in the face of weaker growth.

While harmonization of the VAT would be the first-best option in order to tackle the fiscal deficit, second-best options for tax reform would be preferable to further real expenditure reduction.

A cautious approach to monetary policy is necessary given the need to retain the credibility of the inflation targeting framework on the one-hand and the risks surrounding the external outlook on the other.

The "corto" works well—when all is said and done it operationalizes monetary policy effectively.

There is vulnerability to further external shocks—but by and large the tools exist to deal with even a relatively large shock.

We would welcome staff's views on which structural reforms should be an immediate priority.

Mexico's authorities have skillfully managed the economy during a period of increased risk aversion in international financial markets and a sharp slowing of growth rate in its key export markets. The performance of the economy over this period is testimony not only to recent macroeconomic management, but is also a payoff from a longer period of institutional and policy reform aimed tackling head-on the sources of economic vulnerability. As Mr. Beauregard has pointed out, political maturity has also provided an important anchor for economic stability.

Another central aspect of the Mexican experience has been the translation of economic growth into a marked reduction in poverty. This reinforces that growth is not an end in itself, but an essential ingredient for raising living standards.

Key aspects of the policy framework in Mexico bode well for the future, in particular, the intention to formalize the medium-term framework for monetary policy, and the increasing focus on placing fiscal policy in a medium-term setting in the National Development Plan (NDP). While recessions are never welcome, the most telling line in the staff report is that the 2001 recession was the first in recent Mexican economic experience that was not associated with a domestic financial crisis.

Our overall impression is that the authorities have a good appreciation of the need to continue addressing the remaining weaknesses through structural reform and fiscal consolidation. There seems to be broad agreement between the National Development Plan (NDP) and the challenges identified by staff. We support the authorities efforts in these areas, and offer some comments on fiscal and monetary policy, and a question on priorities for structural reform.

It is worth recalling, however, that a number of challenges identified in the current paper are similar to those identified in the past, in particular, the urgent need for fiscal consolidation and a broadening the sources of revenue. That is not to say that the authorities have been standing still – while the tax reform package fell short of the administration's intentions, it did amount to an adjustment of over 1.5 percent of GDP.

While we agree that further harmonization of the VAT may be the first-best option to underpin fiscal consolidation from a theoretical view, this proved a very difficult issue in the last tax package. Alternative mechanisms of strengthening revenue will probably need to be looked at. It is likely that a concerted effort to raise revenue, given the current low level of revenue and impending fiscal pressures, will prove more durable than a substantial tightening in real expenditure that would be need to achieve the targets set out in the NDP.

Like many monetary authorities around the world, the Mexican authorities' have to set policy against the background of a global economy that, while expected to resume growth slowly, faces risks which on balance suggest a high degree of caution. Firm commitment to further fiscal consolidation in 2003 would underpin a supportive monetary stance.

The use of settlement balances to operationalize monetary policy continues to work well. On the one hand, a move to a direct interest target would reduce interest rate volatility and might even come at little or no cost in terms of increased volatility in other financial variables. But we can also understand the need to maintain continuity in the operational framework until a low and stable rate of inflation is well embedded. This is an area that is probably worth keeping under review.

The useful section on external vulnerabilities suggests that a strengthening in policies, and in particular, the important steps to improve the financial sector, provide a firm foundation for Mexico to weather future external shocks. The full use of the flexible exchange rate in the event of pressures on the capital account would assist adjustment, and the vulnerabilities of the public debt dynamics are linked more to developments in short-term interest rates. We encourage the authorities to continue their policy of seeking to extend the maturity of public debt and, over time, reduce its dependence on short-term interest rates as conditions permit.

While a more significant negative shock may put pressure on debt ratios, the required fiscal adjustment to stabilize these ratios would remain well within the authorities' reach. However, this section also shows forcefully that to reduce the remaining vulnerabilities, the authorities will need to follow through on fiscal consolidation to stabilize and reduce debt levels and structural changes that will increase potential growth. A medium-term perspective on fiscal consolidation and debt sustainability is encouraged.

More information would have been worthwhile on the structural policy agenda in the NDP. The list of reforms in the NDP all seem worthwhile from first principles, but we imagine it will be difficult to advance on such a broad range given the political situation. We would welcome staff's views on which measures are likely to give the authorities the most return for their efforts.

Mr. Bennett submitted the following statement:

Key Points

Mexico's recent progress shows the benefits of the reforms undertaken since 1995. The timely implementation of the administration's structural reform package will help to consolidate these gains.

Vulnerability analysis in the report shows that Mexico would be able to withstand a variety of adverse shocks without a permanent deterioration in the debt-to-GDP ratio. However, we urge the authorities to persevere with their intentions to reduce the public sector borrowing requirement and public debt to decrease vulnerability to adverse shocks.

The efforts by the authorities on strengthening governance and fighting corruption are welcome and will pay long-term dividends.

Decreased Vulnerability to External Shocks

Since its last Article IV consultation, the Mexican economy has weathered its first recession in recent history that was not accompanied by a domestic crisis. This success can largely be attributed to the authorities' efforts at improving macroeconomic stability in the economy through fiscal and monetary policy prudence. Mexico has, to date, also been quite immune to the economic and financial crises plaguing many of its Latin American neighbors due, in no small measure, to its strong macroeconomic fundamentals which has made it an attractive and stable destination for Latin American investment.

We would like to thank staff for their analysis in the selected issues papers. In particular, the assessment of fiscal and external sustainability was noteworthy in that the conclusion is that Mexico is better placed now to weather the effects of a slowdown in GDP growth, a real interest rate increase, or a primary balance decline. While gross public debt as a percent of GDP would increase initially in response to these shocks, once the impact of the shock fades, the debt-to-GDP ratio would start to decline. In contrast, the effect of a combined shock with lower fiscal adjustment, an increase in real interest rates and a fall in the economic growth rate would lead to a sustained rise in the debt-to-GDP ratio. Additional stress tests based on a repeat of historical capital account crises indicate that the associated potential financing gap would not exceed 50 percent of total international reserves.

But Revenue Effort should be Increased

These encouraging scenarios notwithstanding, we agree with Staff that without additional permanent sources of fiscal revenue, the fiscal targets for 2003 and the medium term are at risk. We commend the authorities for adhering to the deficit targets in the face of decreased revenues by cutting expenditures, but increasing revenues would certainly make the task of meeting the targets easier. Table 8 shows tax revenue as a percent of GDP decreasing over the medium term from their already low levels, in comparison with other middle-income countries and many Latin American counterparts, in the absence of further efforts to increase revenues. We encourage the authorities to continue with their recent efforts to broaden the tax base and increase tax compliance.

Credibility is Important

As noted in Mr. Beauregard's preliminary statement, monetary policy has been managed prudently to achieve an annual inflation rate not greater than 4.5 percent and the authorities remain committed to take further action if needed to achieve the inflation target set for 2002. We welcome the emphasis placed by the authorities on the one instrument/one objective framework and agree that targeting other variables would only undermine the credibility that Banco de México has gained in recent years, placing the nominal anchor of the economy at risk. We support the authorities in their commitment to meeting their inflation targets. Credibility is hard to gain but easy to lose.

We also welcome the authorities' efforts on fiscal policy to meet the deficit targets and commend them for the credibility they have built in this area. They not only have a solid track record of adjusting public expenditure in response to adverse developments, but important efforts have been made in order to promote a more efficient use of resources and an increase in savings in the Executive branch. Public debt management has continued to be geared at extending the maturity profile, reducing currency risk, and lowering the cost of the public sector debt.

However, delivering on the structural reforms proposed in the NDP will be important in order to increase the economy's capacity to deal with shocks and increase growth and productivity. The labor market reforms proposed in the NDP, in particular the plans to reduce non-wage hiring costs and rationalize certain legal requirements, are welcome. We note the current administration's lack of a majority in Congress but urge them to continue efforts to build the consensus necessary for implementing the structural reforms in the NDP. In this respect, developing a public communications strategy to build broad-based support for the development strategy may be useful.

Inextricably linked to credibility is transparency. To that end, we welcome the authorities' decision to publish the Staff Report and the Selected Issues paper. However, we would also encourage them to publish the supplement to the Selected Issues which assesses fiscal and external sustainability. The conclusions in the supplement underscore the fact that Mexico's successful implementation of reforms will allow the country to successfully withstand a variety of shocks. Mexico does have vulnerabilities, but these are small relative to other countries in the region.

Continue current focus on governance and corruption to avoid reversing investor sentiment...

We support the emphasis placed by the authorities in their medium-term economic strategy on fighting corruption and improving the quality of public administration. However, we urge the authorities to not waiver in their commitment so as to avoid jeopardizing the gains achieved which have made Mexico an attractive place to invest.

Conclusion

Mexico has undertaken a remarkable transformation since 1995. The adoption of a flexible exchange rate, a move to inflation targeting, improvements in debt management, and a strong focus on trade have all contributed to Mexico's success. Clearly though, there is no room for complacency. We agree with the assessment by Staff that slippages in implementing planned fiscal and structural policies could still leave the economy vulnerable to adverse shocks. As Mr. Beauregard notes in his preliminary statement, a reduction in poverty levels and improvement in income distribution will not be achieved if the macroeconomic stability that has been present in recent years cannot be consolidated.

We encourage the authorities to continue with their efforts to undertake the immediate policy priorities and to continue their track record of economic policy discipline. We wish them every success in the future.

Mr. Wijnholds submitted the following statement:

As a member of this Board, I have participated in many discussions on Mexico, including those following 1995 crisis, and more recently the 1999 program. Over the last two years, Mexico has had to endure a severe economic slowdown, due to the crises in Latin America and the recession in the United States. A more negative external environment for Mexico is hardly imaginable. Nevertheless, the country has weathered these external developments well and I think we can safely conclude that the Mexican economy is more stable than ever and well poised to enjoy high sustainable growth. This was underlined by the recent issuance of a 20-year bond at a remarkably low spread. Of course, there are still a number of areas that deserve extra attention, but before I address these, I want to commend the authorities for their skillful economic management over the past years. They have guided Mexico from severe financial crisis to investment grade. Their example provides a cogent lesson for others on what can be achieved with strong and consistent policies. The challenge is to continue with the good work, in order to achieve long-term high growth.

I welcome the authorities' announcement of a medium-term economic program. This underlines their long-term view on economic policy. Furthermore, the fact that they included both a high-growth 'reform' scenario and a low-growth 'muddle-through' scenario demonstrates a sense of realism. The real GDP growth under the 'muddle-through' scenario is in my view too low for a country with Mexico's potential. Furthermore, real per-capita growth would be even lower under this scenario (I believe about 1.7 percent on average) and this would not be sufficient to reduce the still high incidence of poverty. This underlines the need for at least partial implementation of the structural reforms contained in the medium-term economic program. In the large body of material provided by staff, I could not quickly find any discussion of, or even data on, unemployment. Perhaps staff could elaborate a little on the situation in the labor market, so as to provide some background for the growth estimates.

A major challenge for the authorities concerns the public finances. Although 2002 revenues are projected to reach the 'historically high' level of 13 percent of GDP, I believe this is still too low. Comprehensive tax reform and an improvement of tax administration are clearly needed. Unfortunately, the stripped tax package that was approved by congress in early 2002 falls far short of the authorities' original plans. In particular, I believe a reform of the VAT, to bring rates to uniform levels is unavoidable. However, the staff report suggests that congressional support for such measures might not be forthcoming and external analysts support this view. Like staff, I strongly support the authorities' aim to reduce the public sector borrowing requirement, as currently it remains too high. Over the medium-term, fiscal pressures might come from the underfinanced pension system. I am glad the authorities acknowledge the need for action and I hope this will also lead to actual implementation of pension reform. In absence of improvement of the fiscal position, the sustainability of public debt is all but secured and I strongly welcome staff's excellent analysis in this regard. The discussion in the staff report and the vulnerability analysis in the selected issues paper should help build a domestic consensus for further fiscal reform. I also support staff's recommendation—in the fiscal ROSC—for the establishment of a medium-term fiscal framework.

With regard to the management of public debt, I agree that the authorities have taken praiseworthy steps to reduce the risks associated to its public debt. I believe this has been one of the factors that has helped Mexico shelter itself from the financial turmoil in the region. Nevertheless, I note that still only 8 percent of the domestic debt is contracted at a fixed rate. During the past years with declining interest rates, this might actually have benefited Mexico, but it has also left the country vulnerable to sudden reversals in market sentiment. In the selected issues paper, staff describes the possible risks in full detail.

As for the external debt, I agree with staff that the Investor Relations Office plays a very useful role and here Mexico also sets an example for other countries. I would be interested to learn whether Mexico uses CACs in its foreign bonds or whether staff has discussed the use of CACs in future issues with the authorities.

Given last year's discussion, I would have expected to see a bit more about the financial sector and capital adequacy in the report. Although I agree with staff that the overall health of the financial sector has continued to improve, I believe that some banks remain undercapitalized. I also understand that the consolidation of state-owned banks is still in its very early stages. Perhaps staff could elaborate a little more on the health of the entire banking sector?

On monetary policy, I agree with the authorities that there seems to be little room for further easing of monetary policy at this time. The recent depreciation of the peso has also eliminated the possible need for further easing, without leading to inflationary pressures. I also—for the first time—

agree that reserves appear to be adequate, at 125 percent of short-term debt. The continuing accumulation of reserves has been another important factor contributing to Mexico's relative immunity to the region's financial crisis.

The monetary easing and subsequent depreciation of the peso have helped to turn around the gradual loss in competitiveness to some extent. Nevertheless, I remain concerned about Mexico's competitiveness and I believe developments in this area could have been discussed in some more detail. In particular, the slow pace of structural reform, such as in the energy and telecom sector and in the labor market, raise concerns about a further loss of competitiveness. Unfortunately the staff report does not address these structural issues in much detail. I believe that a speedy implementation of the reforms is crucial and I am therefore worried to read that the political support might not be sufficient.

Finally, I was glad to see that last year, for the first time, the authorities agreed to publication of the Article IV report. I assume that they will continue this positive trend by publishing the current report.

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

A sluggish U.S. and world economy continue to hinder Mexico's recovery prospects in the next year. Notwithstanding the positive market sentiments reflected by sustained and significant FDI flows and narrow sovereign bond spreads, Mexico is not immune to a weakening in financial markets arising from a generalized low appetite for risk and uncertainties on the recovery of global growth. The main challenge ahead—underscored by the staff in a well-written Article IV consultation report—is to adequately determine the policy stance to face exogenous shocks, including the rebalancing of trade deficits and capital flows worldwide, and the subsequent effects on trading partners demands and financial volatility.

After suffering the first recession in recent history not associated with a domestic economic crisis, the Mexican authorities are to be commended for the opportune rebalancing of the policy mix, tightening fiscal policy and taking a more supportive monetary policy stance. The policy response has helped achieving a satisfactory performance, setting the stage for a rebound in domestic demand, employment and economic activity—as confirmed by the staff representative in Mexico—and allowing an orderly resolution of the protracted economic slowdown in 2001. Mr. Oyarzábal and Mr. Beauregard's enlightening preliminary statement clearly depicts the many obstacles and challenges faced by the authorities in implementing this change and the laudable commitments assumed towards making Mexico more resilient to external shocks.

Last year we have emphasized that the reform program undertaken by the authorities -including trade and capital account liberalization, increased private sector participation in key sectors of the economy, tax reforms, changes in labor market structure, capital market liberalization, and pension system reforms- has enabled the economy to take advantage of the benefits of globalization, while reducing the risks inherent to this process. Against this background, we would like to reiterate the benefits for Mexico arising from the integration to its partners in NAFTA, including attracting sizable amounts of foreign direct investment flows that have helped to spur innovation and economic growth. Openness to trade and investment arising from the strong links to the U.S. and Canadian economies are behind the intensive use of economies of scale and technological transfers that play a key role in making the Mexican economy more resilient.

The launching of the National Program to Finance Development reveals the decided commitment of the authorities not only to increase potential output through additional productivity gains and reinforced competitiveness, but also important, the strengthening of domestic sources of financing. The latter will surely provide Mexico with an additional shield against exogenous shocks and the sharp erosion of investor confidence and heightened risk aversion that currently affects emerging market economies. In particular, it is heartening to learn that the authorities have paid special attention to strengthening the legal, operational, supervisory and regulatory framework of the financial sector, severely affected by the crisis in 1995. At the same time, the increases in public sector savings, private domestic savings and external savings are commendable. It is critical at this stage of the development process to contain absorption of financial resources by the government and to buttress external savings as a complementary element to foreign direct investment. We concur with the staff in supporting the structural reforms envisaged in the program that, if fully implemented, will enable high rates of growth thereby facilitating the reduction of poverty and the increase in employment.

Fiscal Policy

At the center of the authorities efforts to implement the medium-term economic program lies the frontloading attempt to fiscal adjustment in 2003. We urge the authorities to adopt and implement the envisaged fiscal strategy to consolidate the favorably public sector debt dynamics. As we mentioned above, focusing the effort on reducing current expenditure—including quasi-fiscal operations—and scaling down capital outlays in a manner that ease the pressures on real interest rates and bolster savings is paramount for enhancing market credibility. Additionally, the adherence to a strict fiscal adjustment path would ensure the reduction of total gross public sector debt, particularly in light of the goal of reducing fiscal vulnerability to oil price volatility. We welcome Mr. Oyarzábal and Mr. Beauregard's candid recognition of the risks associated with the rollover of domestic debt and with an increase in peso denominated interest rates on the gross financing needs of the public sector. The authorities efforts to develop a long-term yield curve and the adoption of a proactive liability management strategy are commendable. At the same time, regarding the preliminary methodology proposed in "Assessing Sustainability", we welcome staff's recognition of its limitations, for example, when simulating shocks to nominal interest rates for countries such as Mexico that have experienced significant disinflation. We would like to underscore, therefore, the need for nuance and considered judgment when drawing conclusions from such simulations in all future cases.

Concomitantly, an integral tax reform aiming at reducing the public sector's dependence on oil-related revenues, should allow Mexico to reduce the vulnerability to external shocks. We regret the lack of congressional support to further advance tax reform legislation—mentioned by the staff on page 17—especially on issues such as broadening the tax base, improving tax compliance, lowering barriers to entry to the formal economy and improving the neutrality of the tax system. Notwithstanding the helpful assistance of the World Bank on tax administration reform, Mexico would favor from a simplified and more efficient fiscal code, that will not only facilitate compliance and enhance its administration, but it will also strengthen the government's fiscal stance towards reducing the public sector borrowing requirements.

We welcome staff's analysis and projections regarding gross external financing requirements for next year. The progress in reducing the risks associated to public debt—based on the authorities efforts to improve the amortization profile of the external debt—together with the possibility of issuing oil-backed securities in times of crisis, depict a scenario of low vulnerability.

Monetary Policy and the Financial Sector

The Mexican economy benefits from little exposure to contagion and differentiation from other emerging market economies through the prudent implementation of the floating exchange rate system that helped the country to absorb external shocks in an orderly manner. Floating has given room for an independent monetary policy that has been key in limiting the effects of the worsening of external conditions in macroeconomic stability.

The authorities pledge to the inflation-targeting framework as an appropriate nominal anchor for the Mexican economy deserves recognition. We welcome the authorities intentions—detailed in Appendix Box 4—towards further formalizing the inflation-targeting framework. Adopting a long-term inflation objective and the introduction of pre-established dates for meetings of the Bank of Mexico are important steps to strengthen credibility and transparency in the use of the framework. We would like to underscore the importance of the announcement of specific inflation targets for the short, medium and long run that eliminates policy uncertainties. Carefully explaining the convergence process towards the long-term target and the roles played by the existing output gap, the pass-through of the peso depreciation and of wage adjustments in the framework of an inflation report, would be very important to secure policy credibility in the midst of turbulences.

We command the Central Bank's recent relaxation of monetary policy in light of the slowdown in economic activity, higher output gap and implications for future inflation. The lower level of domestic real interest rates is now inducing a more positive stance for medium size firms and is benefiting the economy as a whole through a faster recovery. Close monitoring of inflation prospects is required, and monetary policy should be adjusted so as to meet the announced targets, as credibility is essential and particularly fragile during this initial phase of application of the framework. However, we would also caution against an overkill, and underscore that the inflation target has been defined symmetrically.

We concur with the authorities that the use of the "corto" constitutes an efficient and practical policy instrument to which the Mexican financial system is already adapted to. However, we associate ourselves with the staff in underlying that the direct targeting of interest rates would enhance transparency in the conduct of monetary policy, and reduce volatility of short-term interest rates and of the yield curve. The inflation-targeting framework would be reinforced by adopting an interest rate-based operational target that would convey more effectively policy signals. However, this transition entails costs and the authorities should conduct a careful review of the conditions required for switching towards an interest rate operational target before adopting this more adequate system. In this regard, we would like to ask staff to evaluate the formal implications arising from the compulsory deposit to be established at the Bank of Mexico for an indefinite period as announced by the staff representative.

The resilience of the financial system has been appropriately reinforced by means of reductions in the BOM's credit risk associated with the payments system, by the adoption of resolution procedures for non-viable banks, and by the increasing compliance with international standards. Additionally, we welcome the authorities approach towards development banks involving legal reform and tightening monitoring to control quasi-fiscal activities and to enforce clear mandates. In this regard, the imposition of tighter regulatory standards on state-owned development banks and the legislation that allows creditors to rapidly collect on loan collateral are steps in the right direction to further increase the resilience of the system. The recent improvements in the financial system emerge as a key component of the structural reform process. In this connection, we welcome the authorities expeditious resolution to create the "Committee for the Modernization of the Financial System" as a follow up of the recent FSAP review thereby providing a constructive background for further improvements in the financial sector. The decline of bank lending to the private sector—analyzed in Box 3—should not be observed as a point of concern. Moreover, the steadily increase in non-bank and foreign financing since the crisis of 1994–1995 signals the lower exposure to a bank run in the banking system.

Lastly, Mexico has demonstrated its resilience to external turbulence and heightened risk aversion, by weathering the adverse impact of the economic slowdown in the United States, its main trading partner. The medium-term vulnerabilities are directly connected to the commitments of the authorities to the implementation of fiscal reforms. We remain confidence that the progress in structural reforms complemented with a considerable improvement in the financial and fiscal sectors, provide a favorable environment for further improvements.

Mr. Reddy submitted the following statement:

We thank the staff for its comprehensive report for the 2002 Article IV Consultation accompanying a set of excellent selected issues paper on vital issues. We also commend the detailed preliminary statement by Mr. Oyarzábal and Mr. Beauregard. These papers bring out several positive aspects of recent experience with Mexico, despite some adverse impact of recent global slowdown on the Mexican economy. This amply demonstrates how sound macroeconomic policies combined with sound political economy can support recovery, build up international investor confidence and sustain growth and stability. The economy has shown significant resilience in recent years and policies have yielded constructive and enduring results.

We find that almost on all aspects the staff view and the authorities view go together and are well balanced. We also broadly agree with the staff appraisal. Our brief comments are on three aspects, namely, the transition in the monetary policy framework, debt management and the fiscal and external sustainability analysis.

As regards the monetary policy framework, we appreciate the cautious approach followed by the authorities in moving towards a full-fledged inflation-targeting framework and to phase the transition up to beginning of 2004. We tend to agree with the preliminary statement that it is important to recognize that exogenous factors beyond the control of authorities have unpredictable effects on headline inflation. The staff has supported a policy of directly targeting interest rates on the ground that it is an element of more formalized inflation targeting scheme. At the same time, the staff has recognized that the "corto" has worked very well. We would like the staff to elaborate on the point how they consider interest rate targeting a superior approach to the present “corto”. Secondly, we request the staff also to clarify the point raised in the preliminary statement on the potential risks of moving towards interest rate targeting in the present environment. In our view, given the track record of success in monetary policy which has brought down the inflation rate well below the official target, enough flexibility must be available to the Mexican authorities in managing monetary and liquidity conditions. We, however, tend to agree with the staff’s caution in the present environment against tightening monetary policy prematurely in the light of low core inflation, sizeable output gap and uncertainties about the magnitude and timing of economic recovery.

On debt management, in terms of both techniques and also transparency, Mexico stands out as a good example. We particularly commend the authorities effort in reducing the external debt amortization from US$51 billion to US$39 billion between 2001 and 2003. In particular, we appreciate the current policy of gearing towards reduced external vulnerability combined with active liability management and development of domestic debt market. While the average maturity of debt has been reduced from 538 days in 2002 to 793 days since June 2002, there is perhaps some room for elongating average maturity. Secondly, though longer maturity bonds are issued, most of the instruments appear to be linked with short-term interest rates. In this framework, we consider that it would be difficult to develop the proposed long-term peso-yield curve. While we recognize the importance of investors learning to assume new financial risks, it may be necessary for the authorities to move determinedly in the direction of developing medium to long-term bond market.

The selected issues paper and the conclusions by staff on the fiscal and external sustainability are commendable. This is in the right spirit of making bilateral surveillance more effective. However, a point worth considering in fiscal and debt sustainability analysis is whether there should be a uniformity of approach in making the sensitivity test. In particular, in the case of Mexico, a question arises whether a potential replay of past capital account crises is warranted as indicated in paragraph 40 of the staff report. Even though this analysis shows low vulnerability of the Mexican economy, we agree with the preliminary statement that replicating the past crises today would constitute an extraordinary shock the probability of which is rather negligible in the case of Mexico. In this light, we would strongly urge that even extreme case scenario in sustainability analysis should have some reasonable probability of occurrence before they are incorporated as part of staff report. The staff comments are welcome.

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

Mr. Rustomjee submitted the following statement:

We thank staff for a well written report and Mr. Oyarzábal and Mr. Beauregard for their very helpful and informative preliminary statement. Economic growth in Mexico is estimated to have averaged 3.9 percent a year during 1997–2001. The improvement in output growth since the mid—1990s can be attributed to a recovery in total factor productivity, associated with greater macroeconomic stability, technology transfer resulting from a sharp increase in foreign direct investment, and significant structural improvements. We note however that economic slowdown in the United States precipitated a sharp weakening in Mexican economic activity in 2001 from the rapid pace in the preceding year. We therefore welcome the positive signs of a rebound in economic activity which emerged in the second quarter of 2002, with the inflation rate slowing down to 4.4 percent at end-2001, below the target of 6.5 percent, and the external current account deficit narrowing to 2.8 percent of GDP in 2000.

Since we concur with the thrust of the staff appraisal, we will limit our comments to some key issues for emphasis.

Fiscal Policy

We commend the authorities for maintaining prudent fiscal policies in the face of weak economic activity. We note that the authorities have made substantial progress in improving public sector debt management, which has resulted in a lower cost of funding, longer maturities and reduced external vulnerability. Furthermore, we welcome the considerable progress made by the authorities in the development of a domestic debt market, thereby shifting the debt profile increasingly toward issuing fixed-rate instruments with longer maturities, and as a result facilitating an important increase in the average maturity and duration of its domestic debt.

We concur with staff on the importance of taking additional revenue measures to reduce dependence on oil revenue and to ensure the achievement of the medium-term fiscal targets. We note the authorities' willingness to continue to press for further tax reform, including the harmonization of VAT rates, despite the difficulty of obtaining congressional support for such measures in 2003. Their efforts to increase revenue through an improvement in tax administration, although this can not adequately substitute for a more fundamental strengthening of non-oil revenue is also welcome.

On the expenditure side, we note the authorities' fiscal consolidation efforts which is central to the growth scenarios, with a reduction in the public sector borrowing requirement (PSBR) to around 1.75 percent of GDP by 2006. Reducing the PSBR and public debt over the medium term is in our view a very significant element of the authorities' economic strategy. In order to meet the budget deficit target, we concur with staffs' recommendation to the authorities to consider implementing additional expenditure cuts so as to cover about one-half of the revenue shortfall provided that these reductions are socially sustainable. We welcome the authorities' determination to adhere to the 2003 fiscal target which is critical in ensuring that the medium-term objectives are met and investor confidence is maintained, while allowing for a recovery in credit to the private sector and a reduction of pressures on the external current account deficit.

Monetary Policy

We note that in the light of the recent up-tick in inflation expectations and the international market turbulence, there appears to be little room for easing monetary policy and we therefore concur with staff that the current monetary stance appears appropriate under the prevailing circumstances. We would urge the authorities to stem any action against tightening monetary policy prematurely in the light of the low core inflation rate, sizable output gap, and uncertainties concerning the timing and magnitude of the economic recovery.

We welcome the authorities' adoption of a long-term inflation objective, and the introduction of pre-established dates for meetings of the Bank of Mexico (BOM) in order to enhance the transparency of monetary policy and to improve communications with the markets. We also note the authorities expectations that currency depreciation would correct the negative net worth of the BOM. In as much as it would be desirable to modify the BOM's law to introduce automatic transfers from the federal government to replenish the BOM's capital as recommended in the 2001 FSSA, we urge the authorities to seek to replenish the BOM's capital and reserves before transfers of BOM profits to the federal government resume in the future.

Financial System

We are pleased to note that the health of the financial system is good. We commend the authorities for the additional measures being introduced to increase the system's resilience and move towards international standards. In as much as this resilience has to be fully tested through to a broad-based resumption of bank lending to the private sector which has still not occurred, we encourage the authorities to further strengthen banking supervision toward achieving full compliance with international standards, and at the same time increase the resilience of the banking system to shocks, including through the adoption of resolution procedures for nonviable banks.

External Sector Policies

Notwithstanding the projected rise in external borrowing by the public sector, total external debt is projected to remain broadly unchanged at around 27 percent of GDP. We note that external debt as a share of exports of goods and services and transfers, would decline by 30 percentage points to 108 percent by 2007 while total external debt service would fall slightly to reach 22 percent during the same period. We concur with staff that additional structural measures could be an appropriate means to further increase productivity and that targeting the level of the exchange rate would be inappropriate in the context of their inflation-targeting framework. This is because, despite the recent depreciation of the peso, the real effective exchange rate has appreciated significantly in recent years, raising some concern about the risks of a possible sharp downward correction. We note that the authorities' sustained increase in export market shares and the recent narrowing in the non-oil current account deficit is an indication that Mexican exports remained competitive.

We welcome the authorities' continued progress in trade liberalization and their commitment to multilateral agreements as well as their proposal to expand further their web of bilateral agreements to include Japan. It is observed that the active use of bilateral and regional agreements in their pursuit for trade liberalization had been beneficial, resulting in a generalized increase of Mexico's trade with all of its trading partners.

Remaining Vulnerabilities and Capacity for Policy Reaction

We urge the authorities to implement the planned medium-term fiscal adjustment and structural reform agenda, in view of the fact that a lackluster recovery of the U.S. economy or failure to implement such policies could lower economic growth prospects and increase the economy's vulnerability. We welcome the authorities' determination to further improve public sector debt management based on continued emphasis on the issuance of fixed-rate instruments, and establishing benchmark issues in the domestic debt market.

We further urge the government to intensify the monitoring of the corporate sector so as to include privately-owned companies in order to obtain a more representative picture of the entire corporate sector.

Structural Reform

Poverty remains an endemic challenge in Mexico, and the gains in formal sector employment have not been reflected in a notable reduction in the size of the informal sector, with the existence of sizable regional disparities in growth. We welcome the authorities' plan to increase per capita economic growth and the realization that this will require further fiscal consolidation as well as structural reforms aimed at strengthening external competitiveness, increasing productivity, and further strengthening the financial sector.

We urge the authorities to pursue full implementation of the structural reform program, since the government's reform agenda includes: energy sector reform to increase capacity to match the growing demand; improved labor market flexibility; liberalization of the telecommunications sector; reform of the judicial system, including improving governance; and tax reform to increase non-oil revenue.

With these remarks we wish the authorities well in their future economic management endeavors.

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

Mexico has enjoyed economic growth and stability over the past several years and suffered little from recent emerging-market turbulence. That is not an accident. Fiscal discipline, appropriate monetary policies, a flexible exchange rate, prudent debt management, extensive reform of the financial sector, greater transparency and pursuit of free trade agreements have characterized policy implementation under recent administrations. The development of a strong institutional structure has underpinned this economic management.

At the same time, Mexico has an open economy subject to sizable external shocks as Mr. Oyarzábal and Mr. Beauregard note in their very informative statement. The staff's excellent analysis of Mexico's fiscal and external sustainability, corporate-sector vulnerabilities, and the potential for balance of payments problems is thus very helpful. It certainly buttresses our belief that Mexico has successfully differentiated itself from other emerging markets. It also lends credibility to the Fund staff's conclusion that Mexico's overall vulnerability to capital account shocks is low.

Nonetheless, the public sector's exposure to domestic interest rate shocks and the reliance of Mexican corporations on potentially volatile dollar financing will require the authorities' continued attention. The authorities are addressing these vulnerabilities by implementing measures that facilitate the development of a domestic capital market, but it will take time. We also agree strongly with the authorities that advancing the fiscal consolidation process is key.

Mexico's Policy Performance is Instructive

We believe Mexico's post-crisis policy performance offers instructive examples for other countries. That policy performance has not been easy, nor without occasional setbacks. External and internal shocks have necessitated politically painful expenditure cuts in several years. Political considerations have resulted in less-than-hoped progress in some areas. But the authorities' commitment to the consistent implementation of sound macroeconomic policies and market-friendly structural reforms has remained unwavering. Indeed, an argument could be made that that commitment has grown stronger over time.

It is noteworthy that the authorities are using their leadership position to educate Mexicans about the need for reforms and to generate support for those reforms. Recent examples include efforts to raise public awareness on the need for social security reform and efforts to build consensus on labor market reforms. We strongly encourage the authorities to continue this practice and extend it to all reform measures.

The authorities have also made good use of a rules-based approach to policy implementation. Nowhere is this more evident than in the fiscal sector. The authorities' adherence to their own rules has built public and investor confidence in their willingness and ability to follow through on policy commitments. To maintain this confidence and the market access that comes with it, we strongly encourage the authorities to continue this approach.

Fiscal consolidation and pragmatic monetary policy remain critical. Mexico's citizens, domestic and international investors, and the official community have responded favorably to the government's reform efforts, resulting in economic growth and poverty reduction. Yet the authorities' implementation of reforms continues unabated, as it should. Further fiscal consolidation, after pausing in 2002, will be necessary in 2003 to meet medium-term objectives and maintain investor confidence. This could prove tricky in an election year, but we have reason to believe, given past performance, the authorities will rise to the challenge. As demonstrated in the past, fiscal discipline has allowed the authorities to use external market financing to ease the adjustment effort.

The gradual implementation of an inflation-targeting framework has helped lower inflation expectations and, in turn, inflation and allowed the authorities to manage structural rigidities in the price-setting process without losing credibility. We encourage them to continue with this gradual approach. In that light, it would appear appropriate to focus the inflation target and policy stance on headline inflation. We also encourage the authorities to introduce pre-established dates for meetings of the Bank of Mexico's policy-setting committee.

Continued structural reforms complement good progress to date. The government's National Development Plan identifies a number of critical areas that require attention. In particular, the electricity and petroleum sectors face daunting investment needs. The authorities' desire to introduce greater private-sector participation in the electricity sector is appropriate. We encourage efforts to pass legislative reforms this year. We also welcome the authorities' intention to undertake labor market reforms and would remind them to be respectful of core international labor standards.

Mexico has made significant strides in recent years to strengthen its institutional framework as highlighted in the Selected Issues paper. Of note are the efforts to implement rules governing relations among the main institutional actors and their interaction with economic agents. As we have noted in past statements, good progress has also been made in improving transparency. Those efforts should continue, including the publication of all the staff documents associated with this discussion.

Development of domestic capital markets is another area where Mexico has implemented substantial institutional reforms. That development embodies very sound debt management principles, including the issuance of domestic long-term fixed-rate public debt. Importantly, it also includes structural changes on both the buy- and sell-sides and improvements to the legal framework governing securities market transactions. As a result, Mexico has assumed a leadership role in the development of domestic capital markets in Latin America also. We urge the authorities to assume a leadership role in the international debt markets by including collective action clauses in bonds Mexico issues in foreign jurisdictions.

Obviously, a deeper, more-efficient domestic capital market is one way to provide credit to an economy. The other obvious way is through a healthy banking system. The authorities have followed a very deliberate approach to restoring banking sector soundness, particularly since 1999. Mexico has enhanced prudential regulations, established more rigorous capital and loan loss reserve requirements, and brought accounting practices closer to international standards. Perhaps most importantly, the authorities fully opened the sector to foreign investment. Those measures have served to improve the credit standing of individual banks, but bank credit to the private sector continues to contract.

One reason may be the lingering concern bankers have regarding creditor rights and the restrictive legal issues involving lending activities, despite the overhaul of bankruptcy laws in 2000. Importantly, the administration has not stood still. We urge the authorities to remain proactive in this area and secure passage of bank-related legal reforms they submitted to Congress in April 2002. Similarly, we encourage the authorities to follow through on their plans to send draft legislation to Congress in late 2002 or early 2003 that would establish a framework more consistent with a least-cost approach to bank resolution.

AML/TF efforts are appreciated. Since Mexico became a FATF member in June 2000, it has made valuable contributions. We encourage Mexico to continue its activity in all aspects of FATF's work, and also within the Caribbean Financial Action Task Force (CFATF). Likewise, we commend Mexico on its actions to prevent the funding of terrorist activities and urge Mexico to continue its efforts to block the assets of all terrorists.

In conclusion, Mexico has come a long way from the 1994-95 crisis through the steady implementation of sound macroeconomic and structural policies. Not content to rest on their laurels, the authorities are continuing Mexico's march toward the level of living standards enjoyed by most of their OECD counterparts. They have correctly seized on implementing policies that foster sustainable growth as the way to get there. As the World Bank's CAS notes, real growth is the most important determinant of poverty reduction in Mexico. We suspect that is the case elsewhere, too.

Mr. Beauregard made the following additional statement:

I would like to make some comments regarding some news released by the central bank prior to the current Board discussion, and also on the issues raised in the statements regarding public debt management, collective action clauses (CACs), and the resumption of bank credit.

The Board of Governors of the Bank of Mexico (BOM) has tightened monetary policy today. The central bank has publicly explained the reasons behind this move. In particular, even though core inflation in Mexico continues to be low—around 4 percent as of August 2002—headline inflation has risen from 4.4 percent in December 2001 to 5.3 percent in August 2002. The behavior of headline inflation has put upward pressure on inflation expectations, with the market now expecting an inflation rate of around 5 percent by year-end 2002, while the target is 4.5 percent.

For 2003, there has not been an increase in inflationary expectations, but the expected inflation rate of 3.9 percent is still above the central bank's 3 percent target. The BOM stressed the need for wage negotiations to be in line with the inflation objective set for 2003 in order to achieve this objective. The Board of Governors also noted in its press bulletin the influence that the international economic environment has in explaining market uncertainty with regard to this year's attainment of the inflation target. Thus, the BOM has reaffirmed its commitment to the inflation targeting regime.

I would like to highlight the importance of consolidating the credibility that the BOM has gained in recent years. Let us remember that past economic and financial crises in Mexico are explained to a great extent by the perceived weak commitment of the central bank to maintain price stability. These crises resulted in severe contractions of economic growth and rising inflation, an outcome that by no means has benefited anyone. Indeed, the central bank takes into account in the analysis the output gap as an important indicator of future inflationary pressures and expectations, together with wage pressures, exchange rate depreciation, and productivity levels among others. Mr. Bennett has a lucid phrase in his statement, saying that "credibility is hard to gain, but easy to lose." In the authorities' view, consolidating the credibility gains achieved by the BOM is key to consolidating the macroeconomic stability achieved in recent years.

Regarding the issue of debt management, I would like to highlight the emphasis placed on this area in recent years. Some Directors noted in their preliminary statements the need to develop a long-term bond market in order to reduce the public sector's reliance on short-term instruments. As pointed out by the staff, as well as in our own statement, this is precisely the strategy that my authorities have been following in recent years by issuing long-term fixed rate bonds. The fact that public sector funding is still highly concentrated in the short-term segment of the yield curve is not the result of a deliberate policy, but a reflection of the time needed to further increase the average maturity of public sector debt. In fact, since the beginning of this administration, the average maturity of domestic debt has increased by almost 50 percent to 793 days as of June 2002.

On the use of CACs, last week Mexico successfully issued a 20-year bond in international markets. My authorities did not include CACs in this bond because, under present circumstances in the national markets, it would have substantially increased its yield. Cost considerations will be important in determining if we include these clauses in future bond placements.

On the financial sector, we fully share the opinion of all those who said that the challenge going forward is to resume the role of the banking sector as a provider of credit to the economy. In this regard, I would like to highlight that both demand and supply considerations explain the sluggish progress on this front. We need to remember that the demand for credit is greatly influenced by economic prospects. Unfortunately, many of the reforms aimed at encouraging a resumption of bank credit were approved at the time when economic prospects were not favorable. As these prospects improve, so will the demand and supply of credit. On the latter, additional reforms recently submitted for congressional approval—with the aim of improving creditor's rights in the collection of guarantees and information sharing among banking institutions—should also help strengthen the role of the Mexican banking system in the economy.

Ms. Lundsager asked Mr. Beauregard how the determination that the inclusion of CACs would have raised the cost of bonds had been established. Available evidence from other countries like Russia and statements made by the staff in previous Board discussions on CACs questioned the assumption that the use of such clauses would increase the cost of bonds. Perhaps Mr. Beauregard could clarify whether the authorities' assumption had been based on feedback received from bond underwriters after proposing the inclusion of CACs.

Mr. Beauregard responded that the authorities had felt that, under current circumstances, the inclusion of CACs would have increased the yield of those bonds.

Mr. Wijnholds supported the authorities' recent decision to tighten monetary policy, which should not be seen as a premature move. Mr. Beauregard had clearly made the case that credibility was of the essence, especially in a time of economic uncertainty. The recent wise and courageous, if not necessarily popular, action by the central bank underscored its independence.

The Acting Chair (Mr. Aninat) joined Mr. Wijnholds in welcoming the recent actions taken by the monetary authorities.

Mr. Lombardi made the following statement:

> At the outset, we would like to express our appreciation to staff for producing an excellent set of papers and for providing us with an updated note on the most recent developments in Mexico.
>
> Mexican authorities need to be commended for implementing sound economic policies, following the eruption of the Mexican crisis of 1994–95. As we learn from the staff report, the joint implementation of structural reforms and stability-oriented macroeconomic policies has widely benefited the Mexican economy so far and has allowed the Mexican authorities to establish a considerable credibility.
>
> Looking ahead, the authorities should carry on with their reform efforts and narrow the gaps with other OECD economies. In this regard, the medium-term economic program as envisaged by the authorities provides a very helpful framework on which to focus the policy strategy. As the staff report points out, potential output growth may increase up to 5.25 percent through the full implementation of the reform program. However, the staff tends to assume a lower figure, on the order of 4 percent. It would be interesting to know from staff which factors are responsible for a different assessment. Furthermore, in commenting on these figures, it would also be important to know what role NAFTA has played in this regard. Has its effect already been factored into the higher potential growth rate estimated for 1997–2001 or might it further increase the output potential?
>
> One relevant aspect on which we would also seek more elaboration from staff is on whether the implementation of the medium-term program aims to address the economic dualism that characterizes the Mexican economy. In particular, we fear that following the introduction of the NAFTA, northern regions may have become more closely integrated with the North-

American economies, while the southern areas may have fallen further apart. The staff may wish to comment on this.

We note that the forthcoming economic reforms envisaged by the authorities are quite broad and range from improving labor market flexibility to the reforming of telecommunication and energy sectors. We would like to express our full support to the authorities in implementing these important reforms. However, if our understanding is correct, measures for strengthening the social safety net in the transition to a more open and efficient market structure have not been envisaged—the staff may provide some clarifications on that.

We focus on this aspect, because inequality seems to be a relevant issue in Mexico and it would certainly increase consensus on the reform agenda if more people could be put in a position to enjoy the benefits of a market economy. In this regard, we are afraid that the historically high level of the tax-to-GDP ratio of 13 percent to be achieved this year is not enough and further efforts are required from the Mexican authorities. We definitely concur with the staff that improvements in tax administration—though very welcome and important—are not a substitute for a broader tax reform. Furthermore, the heavy reliance on oil revenues further adds to the problem. All in all, weaknesses on the revenue side hamper the ability to design and implement relevant programs of social developments and introduce non-negligible rigidities on the expenditures side.

We are encouraged from the staff's simulations that the external position is sound overall and would be able to weather the replay of past capital account crises. However, as the staff report also notes, a number of risks remain. The recent deterioration in the U.S. equity markets and weakening of market sentiment towards other Latin American countries combined with a rise in global risk aversion underlie some vulnerabilities. Notwithstanding the authorities' efforts, Mexico's gross external financing requirements are still large and public debt dynamics remain vulnerable to interest rate increases. For these reasons, we would strongly encourage authorities to remain vigilant and pursue very firmly their announced reform plans.

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

Mr. Mirakhor made the following statement:

I join other Directors in their appreciation of the excellent set of staff papers which, together with the articulate statement of Mr. Oyarzábal and Mr. Beauregard describe well and comprehensively the recent economic developments in Mexico as well as the challenges facing the authorities. I also thank Mr. Beauregard for his earlier statement.

It is a pleasure for me also to join staff and other Directors in commending the authorities for their accomplishments. Mr. Oyarzábal and Mr. Beauregard as well as their authorities should take a great deal of comfort from the staff's and the Directors' complements for the achievement of the Mexican economy in recent years.

I can do no better in recounting these accomplishments than other Directors have already done. Especially noteworthy is the statement of Mr. Wijnholds. Indeed, as long as I have served in this Board with Mr. Wijnholds, I have seldom observed him dole out stronger complements as he has done in his statement on Mexico, especially in the first paragraph of that statement, where he not only suggests that as a result of the authorities' skilful management of the economy, Mexico is well-poised "to enjoy high sustainable growth," but also points to Mexico as a model for other countries. The welcomed news in the staff statement (BUFF/02/160), that there are signs that the recovery may well have started, with growth picking up, employment increasing, core inflation declining, external current account deficit reaching a low level of 2.1 percent of GDP, 90 percent of which is financed by FDI, all confirm the very positive assessment of the economy's performance by the staff and Executive Directors.

As Ms. Lundsager and Mr. Ralyea suggest, "this is not an accident;" it is the result of the hard work of the authorities in implementing structural reforms and sound fiscal and financial sector policies in the last five years. As a result, Mexico has a vastly different economy, and perhaps also a different society as evidenced by the smooth political transition. The economy is much more resilient, and the economic policy environment much more favorable as evidenced by the agility with which macroeconomic policies have been rebalanced, especially over the past three years in response to shocks, external turbulences, and heightened risk aversion, a point well articulated in the staff report, Mr. Oyarzábal's and Mr. Beauregard's, Mr. Lefort's and Mr. Maino's as well as in other Directors' statements.

As Mr. Oyarzábal and Mr. Beauregard suggest in the closing paragraph of their statement, challenges remain. The fact is that the long period of crisis and stagnation that afflicted Mexico from 1982–1995 have led to contraction of output from which Mexico has not fully recovered, and, even now two decades later, output is still estimated to be as much as 30 percent below trend. As a result, reducing poverty levels and improving income distribution have become the policymakers' most important medium-term challenge as is also suggested by Mr. Guinigundo and Mr. di Maio and other Directors. But as Mr. Oyarzábal and Mr. Beauregard quite rightly suggest, to achieve their goals, the hard-won macroeconomic stability has to be consolidated.

With this in mind, we strongly welcome the articulation of the authorities' medium-term economic program, as represented by the National Program to Finance Development 2002–2006 with its emphasis on upfront fiscal consolidation, increase in public and private savings and reduction in the vulnerabilities of the economy, and implementation of structural reforms that not only affect incentives to accumulate capital and to work but also those that increase total factor productivity. In this context, a very important step was taken in 2002, as is also suggested by Mr. Rustomjee, with the enactment of the 2000 bankruptcy law which replaced a law that had been in effect since 1943. The 2000 Law has some innovative features such as the establishment of a board of bankruptcy specialists and emphasis on creditor rights. I wonder if the staff has any information on the working of this law since its enactment, if there have been any bankruptcy cases, and how they were dealt with?

There are also short-term policy challenges; some have been enumerated in the staff report and in other Directors' statements which I will not repeat here, but one which deserves emphasis is referred to in the statement of Mr. Yagi and Mr. Watanabe. The Selected Issues papers indicates that the outstanding credit to the private sector has decreased in real terms and the role of banks as financial intermediaries has been weakened. I agree with Mr. Yagi and Mr. Watanabe that the need to improve the credit infrastructure and accelerate the resumption of credit to the private sector are important remaining challenges. In this regard, I was reassured by Mr. Beauregard's comments at the beginning of the meeting.

Another noteworthy policy challenge on the agenda of the authorities is the continued strengthening of credibility and transparency of monetary policy. In this regard, as the staff report suggests, monetary policy has gained considerable credibility in recent years, and presently it is appropriately geared to achieving an inflation rate of 3 percent in 2003. The authorities are targeting headline inflation, presently at 5 percent, but also looking at the core inflation which has declined to below 4 percent.

Given the need for the continuation of strengthening of credibility, one can appreciate the wish of the authorities to want to err on the side of caution in order to, as Mr. Beauregard puts it, "consolidate what Bank of Mexico has gained in recent years," which is also the spirit of staff report's position on monetary policy, as it sees no urgent need for monetary policy easing at this time, particularly given the strength of recovery in domestic demand reported in staff's BUFF/02/160 and Mr. Beauregard's earlier comments that inflationary expectations are rising. Staff, however, suggest a number of specific conditions under which they would favor monetary easing, and I did not detect any disagreement with the authorities on this score.

Another important issue is the choice of an intermediate operational target for the inflation targeting framework. The staff, supported by Executive Directors' statements, suggests the choice of short-term interest rates. While the authorities do not reject this advice offhand, they suggest compelling reasons, recounted in Mr. Oyarzábal's and Mr. Beauregard's as well as other Directors' statements, why they should, at least in the short run, stay with the "corto" while continuing to analyze the dynamics of inflation to determine if and when to switch to direct interest rates. Given the extent of knowledge and skill of the authorities about inflation targeting framework, one is confident that they would also consider that their objectives of developing a long-term yield curve, establishing the framework for a proactive liability management strategy, developing a domestic debt market as well as the consideration of the risks associated with the rollover of domestic debt and with an increase in peso-denominated interest rates on gross financing needs of the public sector (as mentioned in Mr. Oyarzábal's and Mr. Beauregard's statement) all would suggest that perhaps a more direct instrument of intermediate operational target may serve them well in the medium term.

Let me conclude by joining Mr. Lushin and Mr. Lissovolik and other Directors in welcoming the increases in recent years in real expenditure on social programs which has led to a marked reduction in poverty and improvement in living conditions of the poor. Among the successful anti-poverty experiences in developing countries, Mexico's efforts through the innovative "progreso," with its emphasis on health, nutrition, and education with the main objective of improving the process of human capital accumulation among poor families in rural Mexico, is noteworthy. I wonder if the staff could provide any information on the effectiveness of this program since its inception.

With these remarks, I request Mr. Oyarzábal and Mr. Beauregard to convey to their Mexican authorities the best wishes of this chair for the of their success in achieving a high rate of sustainable growth.

Mr. Lathouly made the following statement:

We would like to thank staff for a comprehensive report, and Mr. Oyarzábal and Mr. Beauregard for their helpful statement.

We note that the overall economic performance of Mexico was mixed in 2001. On the one hand, the authorities managed to bring inflation further down and narrow the gap of external deficit from 3.1 percent of GDP in 2000 to 2.8 percent of GDP in 2001. On the other hand, economic growth declined by 0.3 percent in 2001 from a growth rate of 6.6 percent in 2000. The sharp slowdown in growth was reflected in a marked decline of exports and domestic demand in 2001, compared to 2000. However, if compared to the other countries in the region, Mexico's economy is relatively sound and has great potential for high growth in the future. We broadly agree with the staff's appraisal, but we would like to comment on a few issues.

First, on fiscal consolidation, the authorities' commitment to meet the budget deficit target and to improve the ratio of public debt-to-GDP is commendable. However, we have some concerns on limiting expenditure growth as needed to achieve the fiscal targets, as this may deteriorate the living conditions of the poor if real primary expenditure is substantially reduced. If this is the case, we appreciate the staff's comment on the mitigation measures for the poor sector of society.

Second, on structural reform, we recognize that many of the economic achievements have also been due to a successful implementation of structural policies. While we welcome the government's overall medium-term structural reform agenda, we feel that this is excessively ambitious to be achieved in 2006. We are of the view that a more realistic timing and less ambitious content could give more credibility to the authorities. Staff's comment is welcome.

Third, on the external sector, the current account deficit is expected to be offset by capital inflows throughout the medium term, mainly through FDI flows which the authorities cannot afford to lose. Therefore, the authorities should be mindful to maintain the confidence of foreign investors in order to safeguard the economy from external shocks. Such measures could be a further appropriate mix of monetary and fiscal policies designed to maintain economic stabilization.

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

Mr. Wei made the following statement:

At the outset, let me thank the staff for the comprehensive set of papers and Mr. Oyarzábal and Mr. Beauregard for their insightful preliminary statement. After the outstanding performance of previous years, the Mexican economy declined slightly due to the slowdown of the global economy, in particular the U.S. economy. Given the increased uncertainty in the U.S. economic recovery, prospects for an economic pickup in Mexico have weakened. However, Mexico's recovery remains much more promising than that of most other countries in the region. Nevertheless, as indicated by staff, this slowdown is the first in recent history that is not associated with a domestic economic crisis. The authorities should be commended for their consistent adoption of sound macroeconomic policies and their commitment to further structural reforms aimed at enhancing productivity. Looking ahead, although challenges remain in such areas as debt management and fiscal consolidation, prospects are more favorable than for most other countries in the region as I mentioned earlier. That said, we have the following observations.

Due to the disciplined fiscal framework, the fiscal target remains within reach notwithstanding the weakened economic activity. However, greater efforts are needed to realize an important reduction in the fiscal deficit and public debt by 2006. We share the view that both tax reform and strengthened tax administration are of great importance in achieving the goal. With improvement in the revenue side, the authorities will face less pressure with respect to the need for expenditure control. We note the authorities' endeavors to improve debt management with measures such as lengthening maturities and reducing debt vulnerability to movements of economic variables. However, public debt and public borrowing remains sensitive to changes in interest rates. The bulk of public financing needs continue to constitute potential risks for the public finance.

The monetary policy stance appears to be appropriate for achieving this year's inflation target. Given the rise in inflation expectation there is little room for further easing of monetary policy. We concur with staff that given the still weak economic activity, the benefits and costs of tightening the monetary policy stance should be considered cautiously. We welcome the intention to further formalize the inflation targeting framework. While the continued use of the "corto" is justified in the short run given its effectiveness, to directly target interest rates will be helpful in maintaining interest rate stability and, in turn, reducing the risks associated with the impact of interest rate fluctuations on public finance.

The FSSA findings regarding the health of the Mexican financial system are encouraging and we welcome the measures undertaken by the authorities that are mainly in line with the FSSA recommendations aimed at further increasing the system's resilience to shocks and achieving full observance of international standards.

The general picture of the external sector is sound. While the currency has appreciated significantly in real terms recently, the most recent nominal depreciation could help correct the appreciation. The Mexican export market share continues to grow and the non-oil current account deficit has narrowed. In the context of a flexible exchange rate, the level of international reserves is abundant. We welcome the progress in trade liberalization and encourage the authorities to make greater efforts. We appreciate their intention to actively participate in Doha Round of WTO.

Over the medium term, much work remains to be done with the structural reforms. In addition to the reforms contained in NDP, reforms in taxation and corporate governance deserve further attention. We welcome the initiative to conduct ROSC with respect to corporate governance.

In conclusion, the Mexican authorities are commended for their achievements in maintaining economic stability and pursuing enhanced productivity and higher sustainable growth. We wish them every success in their future macroeconomic management.

Mr. Moser made the following statement:

I can be fairly brief, but I have to say—and I do not say this very often—that I did enjoy reading the very good staff report and the preliminary statement by Mr. Oyarzábal and Mr. Beauregard. But it is also not very often that authorities are proud of the fact that their country has just gone through a recession. However, this pride is fully justified, because it would indeed be a remarkable success if Mexico had finally managed to move from an era of recurring financial crises to one of ordinary business cycles. The conduct of prudent economic policy management and bold structural reforms over the last few years, including trade liberalization, have decisively contributed to this success, and these efforts have been acknowledged by financial market participants and rating agencies. As mentioned by other Directors, the fact that the Mexican economy has so far shown considerable resilience to the regional crisis is an achievement, not good luck. Mexico's experience also shows that liberalization, privatization, and stabilization do deliver the promised rewards, even in Latin America.

The degree of maturation that Mexico has achieved is also reflected in the staff report. The report rightly focuses on Mexico's remaining vulnerabilities, and by doing so it shows that Mexico is able to afford a frank and open discussion of these vulnerabilities.

After reading the report, one has the impression that everything is on the table and fairly under control. The authorities do not only seem to be well aware of the vulnerabilities, but also well positioned to handle them. The progress that has been made in debt management is especially noteworthy and offers an instructive example for other countries.

That serious vulnerabilities and considerable risks remain, and that Mexico needs further progress in different areas goes without saying. The most pressing issues seem to be the low level of tax revenues and the high proportion of short-term domestic debt linked to interest rates. We strongly support the authorities' intention to press ahead on these issues.

Further tax reform, including a much-needed expansion of the tax base, seems crucial to substantially improve the fiscal position and reduce public sector borrowing over the medium term. We also welcome the other elements in the government's structural reform agenda, which should help to maintain external competitiveness and increase the growth potential of the economy and thereby also enhance debt sustainability. Given that the authorities continue their prudent economic policy management—and here I include today's monetary policy decisions—the main risk at present seems to be that the authorities will be unable to advance their reform agenda in the run-up to the 2003 mid-term elections. Progress on these reforms, however, will be important in order to sustain Mexico's success.

Finally, this Chair hopes that the higher degree of maturation that the Mexican economy has reached will also be reflected in the country's publication policy, that is, that the authorities agree anew to the publication of the staff paper. Mexico's authorities have nothing to hide, and the document might help them maintain the political support for their reform agenda. I just stressed "might" in the last sentence, Mr. Chairman, because I cannot promise too much in this respect, after Swiss voters just this weekend declined a Fund-supported electricity reform. I wish the Mexican authorities more success.

Mr. Brooke made the following statement:

Market Differentiation

We fully agree that the Mexican authorities' prudent macroeconomic management, their progress in improving the composition of the public debt and the implementation of structural reforms are yielding good results. As Mr. Beauregard's preliminary statement concludes, proof of this can be seen in the differentiation by investors between Mexico and other EMEs. As Ms. Lundsager and Mr. Ralyea highlight, there are lessons here for other countries. Mexico's performance shows the benefits that can be gained from sound economic policies.

DSA

We welcome the staff's excellent DSA. While complying with the new guidelines, staff have sensibly gone beyond the core elements of the new framework to consider in more detail the factors that are of particular relevance to Mexico. I particularly welcome the way that the DSA has been used to underpin staff's analysis of the main risks facing the authorities' fiscal and structural adjustment programs. There is a reassuring conclusion that Mexico is currently in a good position to withstand most shocks.

Fiscal Policy

That being said, as the authorities and staff highlight, there is no room for complacency. In particular, significant reliance on oil revenues make Mexico vulnerable to domestic interest rate and oil price shocks. Hence, we welcome the authorities' commitment to further reduce their debt level and increase non-oil revenues. I tend to agree with staff, however, that a more ambitious program of fiscal consolidation would be beneficial in reducing the remaining vulnerability more rapidly. In this regard, switching the budget's focus to the more conventional PSBR definition and using privatization receipts to pay down debt would be helpful developments.

Structural Reforms

We welcome the authorities' NDP. It demonstrates a clear sense of focus to implement reforms that will promote growth and reduce poverty. We also welcome the authorities' actions to promote a national debate about these reforms and garner sufficient support to get them implemented. All of the reforms look sensible. That being said, we would like staff to undertake a fuller consideration of the strengths and weaknesses of the various reform proposals in the next Article IV report.

Competitiveness

Like Mr. Oyarzábal and Beauregard, I am not overly worried about Mexico's competitiveness position and its current account deficit. I tend to agree with them that strong FDI demonstrates foreign investors' desire to hold Mexican assets. This is a good sign. A flexible exchange rate should ensure orderly adjustment of savings and deposits should investor attitudes change. Continued structural reforms will of course help to improve competitiveness.

Monetary Policy

We welcome the authorities' plans to strengthen the CB's inflation targeting framework. The key here is to maintain credibility. The Bank of Mexico will be judged by outcomes of its actions. As such, I hope the Bank of Mexico staff will be able to advance their work on modeling future inflation in Mexico and to discuss their findings with staff.

Trade

We support Mr. Lushin and Mr. Lissovolik's remarks about the benefits of multilateral trade liberalization and hope that the authorities will change the focus of their trade negotiating strategy accordingly.

The staff representative from the Western Hemisphere Department (Mr. Kalter), in response to questions from Directors, made the following statement:

There were a few questions in the preliminary statements on structural reforms and their effects on the real economy and competitiveness. Messrs. Guinigundo and Wijnholds asked about the immediate priorities in the area of structural reform, noting that speedy implementation is crucial but that political support might be lacking. As noted in the staff report, all the structural reforms included in the government's NDP are critical to enable

Mexico to achieve a notable increase in per capita growth, maintain competitiveness, and reduce poverty. The achievement of the authorities' high growth path assumes full implementation of structural reform. Significant progress has already been made in reforming the financial sector, with the aim of reinforcing the stability of the banking system and setting the basis for a domestic financial system that is sufficiently deep. In this context, increased domestic savings should provide a sound basis to finance public and private sector debt and credit.

Looking ahead, we agree with the authorities' approach of concentrating on forging consensus for legislation aimed at raising investment in the energy and labor sectors in order to eliminate growing bottlenecks to economic growth. As noted in the staff's statement, the authorities sent to congress in mid-August a proposal aimed at modernizing and increasing capacity in the electricity sector. The proposal involves allowing full participation to the private sector in electricity generation, enabling private generators to sell electricity to large consumers, which are mainly in the corporate sector. This legislation is expected to be considered by Congress within 2002, and a positive sign is that the main opposition party in congress has recently indicated its willingness to consider this reform.

In the area of labor reform, the authorities are still working with business and labor groups to forge a consensus on specific legislation that will hopefully be sent to congress by year-end 2002. We agree with the authorities on the key elements of labor reform needed to reduce existing rigidities. These include a reduction in the sizable non-wage costs that currently characterize labor markets by introducing new forms of hiring, such as apprenticeship contracts and seasonal hiring. Also, there is a need to allow firms to adapt working hours to their individual circumstances, to create greater opportunities for increased training, and to rationalize existing legal requirements among other required measures. In addition, I would like to emphasize the importance that both the authorities and the staff attach to the passage of the VAT reform, especially with regard to the harmonization of the VAT rates.

Regarding Mr. Wijnholds's specific concerns about competitiveness, we fully agree that a slow pace of structural reform would raise competitiveness concerns in the future. At the moment, however, Mexican exports appear to be competitive even if the real effective value of the peso has appreciated significantly—despite the recent depreciation of 15 percent since March 2002. In the staff's view, the current level of the peso largely reflects strong capital inflows following increased market integration in the North American Free Trade Association (NAFTA), as well as strengthened macroeconomic and structural fundamentals. Indeed, as noted in the staff report, the sustained increase in the market share of non-oil exports and the recent narrowing of the cyclically adjusted non-oil current account suggests that the Mexican exporters remain competitive. As described in considerable detail in Supplement 1 to the Select Issues paper, based on a moderate implementation of the planned structural reforms, and on continued stability-oriented macroeconomic policies, the current account deficit is sustainable. Having said that, a lack of real progress in the government's future structural reform program would hamper growth and competitiveness, and increase poverty. Hence, the emphasis given by the authorities and the staff to continued implementation of structural reforms.

Mr. Wijnholds also inquired about the situation in the labor market, asking for background information in this area. In this regard, it is important to note that labor market data are hampered by difficulties in capturing the large informal sector. As noted in the staff report, both real wages and employment have expanded in Mexico in recent years. Tables 1 and 2 in the staff report show how employment has grown rapidly in the formal sector, at an average annual rate of over 6 percent between 1998 and 2000. Part of that certainly represented a recovery from the decline associated with the 1994-1995 economic crisis. Employment weakened in 2001, but there has been a solid recovery thus far in 2002. The recorded unemployment rate is actually quite low in Mexico, at 3 percent. However, this overstates the positive employment picture in Mexico, as it is not representative of the overall state of excess labor supply, and it excludes a large amount of workers that are underemployed. When one looks at the share of the labor force that is underemployed in Mexico, and those that work less than 35 hours a week, then the rate of unemployment has remained steady at around 14 percent in the last year, although it is certainly down from the levels seen in previous years. Regarding real wages, these rose rapidly up until the 1994-1995 crisis. Following a dramatic decline after the crisis, there have been significant increases that have fueled strong consumer spending. The real wage gains have slowed in the current weak economic environment, although they have not stopped.

Turning to questions related to financial sector strength and reform, Mr. Wijnholds inquired about the capitalization of banks and the situation of state-owned banks. As discussed in the staff report, the health of the banking sector has continued to improve. Financial indicators continue to strengthen across the board. From Table VII we can see that the ratio of nonperforming loans to total loans has declined from 15 percent in 1998 to 4 percent in 2001. Among other indicators, loan-loss provisions relative to nonperforming loans have almost doubled during this period and banks' liquid assets are up by 50 percent. A number of other indicators provided in the table and other indicators not reported in the table also show uniformly that the banking system has strengthened considerably in recent years. All but one bank have already met the requirements of regulatory capital that will be in effect at the beginning of 2002, and the remaining bank is expected to comply with these norms by the established deadline. Indeed, the overall capital adequacy ratio currently stands around 15 percent. While such high ratios have been seen in the past, they were not representative of the banking system's capital adequacy, as the measurement of capital did not reflect best international practices. That is no longer true, and therefore the ratio of 15 percent is internationally comparable. In addition, the 2001 FSSA concluded that the financial system has improved its resilience to shocks and is not likely to pose systemic risks. Partly in response to recommendations from the FSSA, many additional measures are being introduced as discussed in the staff report and the Selected Issues paper.

Concerning the state-owned banks, legislation passed by congress in April of 2002 aims at modernizing state-owned development banks through the imposition of tighter regulatory standards, improved accountability, and corporate governance, as well as a clearer definition of their mandates. Importantly, as mentioned in the Selected Issues paper on the institutional framework, regulations have been put in place requiring harmonization of the regulations of state-owned development banks with those of private banks. That being said, it is noteworthy that the role of state banks now is much smaller than prior to the Tequila Crisis, when they were an issue leading to the crisis. Their balance sheets have shrunk dramatically in the last seven years, and they are no longer significant players in the Mexican financial scene.

As regards monetary policy, Mr. Reddy asks why does the staff consider direct targeting of interest rates to be superior to the use of the "corto", and what are the potential risks of moving toward interest rate targeting. Indeed, monetary policy in Mexico is conducted in a flexible manner with settlement balances, with the "corto" as its operational target. Changes in the "corto" alter the amount of liquidity made available by the BOM to commercial banks to settle their overnight balances at a penalty interest rate. Increases in the "corto" thus raise the amount of banks' overnight settlement balances that must be financed at the penalties rate, requiring banks to raise their interest rates to cover these costs, and hence the indirect mechanism between changes in the "corto" and changes in commercial bank interest rates. Changes in the "corto" have proven to be an effective signaling instrument, moving interest rates in the direction intended by the BOM. The lack of a direct interest rate target enables the markets, rather than the BOM, to determine the appropriate interest rate taking into account information from the BOM as well as from market sources. However, this system has also resulted in increased interest rate volatility with implications for the cost of domestic debt. As noted in Box 4 of the staff report, there is no unique relationship between the level of the "corto" and short-term interest rates, and moving to interest rate targeting would convey more effectively the policy signals intended by the BOM. In essence, the transparency of direct targeting of interest rates would improve the signaling to financial markets and reduce short-term interest rate volatility. The staff report notes the importance of that given the high level of domestic debt that is linked to short-term interest rates.

On the other hand, a move to interest rate targeting would likely increase exchange rate volatility. In an environment of high inflation and asymmetric pass through of exchange rate changes to prices, this would introduce an inflationary bias in the system. Thus, as stated in the staff report, we fully understand the authorities' view that direct interest rate targeting should only be implemented once there is strong evidence of success in reducing and maintaining inflation at industrial country levels.

On a related note, the move by the BOM to increase the interest rate right before the current Board discussion is appropriate. It is consistent with the discussions with the authorities on monetary policy reported in the staff report. The authorities indicated during these discussions that there appeared to be little room for easing monetary policy further under current conditions of international market turbulence and in light of the recent uptick in inflation expectations. Subsequently, the exchange rate has depreciated by 15 percent, easing monetary policy conditions, and inflation expectations have risen under current market conditions.

Continuing with questions on monetary policy, Mr. Le Fort asked for an evaluation of the formal implications arising from the increase in compulsory deposits by banks at the BOM. The authorities have indicated that they will face sizable amortizations of bonds in the coming months, and there is also a need to sterilize the projected accumulation of international reserves due to operations of PEMEX discussed in the staff report. In these circumstances, the compulsory deposit requirement will enable the BOM to maintain a daily creditor position in the money market, which the authorities consider to be important to maintain the effectiveness of the "corto". It is important to note that any reduction in the interest rate costs of the BOM resulting from this action was not the stated purpose of the regulatory change. When the deposits were introduced in 1998, the banking system was far less healthy than it currently is, and the BOM decided to pay banks an attractive rate based on the 28 day interbank rate, which is higher than the cost of funds. What the Bank of Mexico is now doing is to level the playing field by paying banks a rate that is representative of the cost of funds, and it is thus not inducing a gain or a loss to banks.

There was also a question from Mr. Yagi on the reasons why significant bank credit has not materialized under the present circumstances, and on the corrective measures that are needed. This topic has been widely discussed in previous Article IV consultations, and conditions appear to be now in place for a resumption of credit. Chapter 2 of the Selected Issues paper notes that, despite the banking sector's consolidation and strengthening in the last seven years, bank credit to private sector has declined significantly in real terms since the Tequila Crisis, so much so that there were jokes that the banking sector is not a problem in Mexico, because it no longer exists. Despite banks' efforts to strengthen their balance sheets and eliminate the burden of nonperforming loans, credit demand remained weak, as the poor functioning of the judicial system limited creditors' ability to collect even on collateralized loans, further discouraging credit provision. In these circumstances, the private sector has relied on alternative sources of financing during the period of sizable economic growth since 1995, including supplier credit, foreign funds, internally generated funds, and nonbank lending. In parallel, the growth of domestic institutional investors, such as pension and mutual funds, has become an important domestic source of financing for corporations.

Looking forward, conditions are now favorable for a resumption of bank credit to the private sector, following a restructuring of bank balance sheets, the significant improvements in the legal framework and the judicial system described in the staff report, low interest rates, and the beginning of an economic recovery. Indeed, the most recent data is already showing an increase in bank credit to the private sector, with nonrestructured loans increasing by 2 percent in the last 12 months. This small increase is just the beginning, and the staff will monitor this trend carefully.

Concerning the remaining vulnerabilities in terms of external financing, Mr. Reddy joined Mr. Beauregard in cautioning that replicating past crises today would constitute an extraordinary shock with a very low probability of reoccurrence, and that such a scenario should thus not be incorporated in the staff report. From an area department point of view, we agree that replicating the crises of the past would constitute a large shock with low probability of reoccurrence. However, it is the very nature of a stress test to focus on extreme events that have relatively small probability of occurring, and to then ask whether the authorities still have the appropriate instruments to address the simulated shocks. The ability to answer this question in the affirmative gives the market confidence in the debtor, and in the case of Mexico such confidence has been a factor leading to investment grade rating. This leads to a critical point regarding the role of staff's vulnerability analysis. An enhanced examination of remaining vulnerabilities does not imply that the vulnerabilities have increased, rather it gives increased credibility to the staff's assessment of these vulnerabilities, thereby enabling enhanced differentiation of risks among emerging markets.

There was also a large concentration of questions on structural and poverty issues, pointing to the need for increased focus in this area in the future. First, Messrs. Mirakhor, Lombardi and Lathouly among others have asked about poverty and the social safety net in Mexico. It is important to note that poverty levels have been declining in Mexico. Both real wages and formal employment have expanded in recent years and, as noted in the staff report, poverty levels have declined from over 60 percent after the Tequila Crisis to about 45 percent recently—more than reversing the sharp increase in poverty associated with the Tequila Crisis. However, it is also true that the informal sector remains sizable and that poverty is a major problem.

Regarding the dualism that characterizes the Mexican economy and the sizable regional disparities, the north continues to be significantly wealthier than the south, with income per capita in the northern region more than double that of the south, and disparity is actually increasing. The north grew at an average annual pace of 5 percent between 1993 and 2000, taking into account the sharp decline during the Tequila Crisis, while the south grew by only half that rate, at around 2.5 percent. To a considerable extent, this asymmetry in regional growth reflects differences in resources, as well as geographic location. The disparities have been exacerbated by differences in transportation, education infrastructure, and more recently by the NAFTA, which is a benefiting the north to a greater degree than the south.

The government is attempting to address regional disparities in a number of ways. A key objective of fiscal policy under the medium-term economic program is to increase public spending on infrastructure, and to reorient spending toward the poorer areas that are mostly in the south. Since 2001, the budget adjustors call for an earmarking of 30 percent of any excess public revenue for investments in infrastructure in the poorer areas. There are also tax incentives for investments carried out outside the main industrial centers. The government has also embarked on the plan of Panama, which is designed to improve infrastructural links between the southern part of Mexico and Central America through substantial spending on infrastructure projects, such as highways, railroad links and ports, as well as interconnections of electricity transmission, agribusiness projects, and development of tourism and "maquiladora" zones. The authorities have already allocated the equivalent of almost \$1 billion in the 2002 budget, and they expect the Inter-American Development Bank and other multilateral and bilateral sources to support the plan with \$4 billion. Finally, the government is attempting to increase financing for small- and medium-sized enterprises through state-owned development banks.

Directors have also raised questions regarding the measures envisaged for strengthening the social safety net. In this regard, I should point out that the most important measures in terms of reducing poverty are those that have helped avoid the recurrence of periodic crises. Indeed, poverty levels jumped in the last crisis and in previous crises, and the avoidance of a crisis in the recent transition should be a major factor for continued declines in poverty. Macroeconomic stability is therefore a pre-condition for poverty reduction.

Regarding more specific measures aimed at reducing poverty, a number of specific programs are in place. Social spending has increased steadily over the past decade, and in 2001 it represented over 60 percent of total discretionary spending, or 10 percent of GDP compared with 6 percent ten years earlier. This has entailed a significant restructuring of public spending, with social spending per capita increasing on an annual basis in the last eight years by almost 13 percent, despite a 5 percent reduction in total discretionary spending per capitechnical assistance, so there has certainly been an emphasis on social expenditure. In terms of the actual micro programs, Mexico is quite well known and used as a prototype by other countries for its "Progreso" program, which has recently been renamed "Oportunidades". The human capital development programs are the cornerstone of the government's antipoverty strategy and they receive the largest share of allocation. The government has been shifting from pure income transfers to transfers conditional on investments and human capital. In this regard, "Oportunidades" provides cash transfers, school supplies, and nutritional supplements to the very poor, conditional on school attendance and preventive health care visits. There are many studies showing that these programs are actually helping. In 2001, over 3 million households in marginal rural areas were covered by this program. There are also fiscal capital development programs and income generating programs.

I will conclude by responding to questions on the bankruptcy law approved in 2002. While experience with implementation of the new framework is still limited, there have already been over 50 cases of bankruptcy proceedings since the new framework was introduced in May of 2000, and about 20 percent of these have been concluded. Although there are no systematic studies, there is evidence that these new laws have eliminated the abuses that were committed in the past, both on the creditor and the debtor side.

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

Mr. Reddy asked whether only extreme case scenarios with a reasonable probability of occurrence should be included in sustainability analyses in staff reports. It should be noted that the sustainability analysis of external and public debt dynamics, and the templates presented in Supplement 1 to the Selected Issues paper subjected medium-term scenarios to shocks of one and two standard deviations. Shocks of these magnitudes are consistent with the Board's discussion on debt sustainability analysis held in June 2002.

In addition, the supplement presents a stress test describing the implications for the Mexican capital account of a replay of the three capital account crises that have taken place in the past seven years. Without speculating about the reasonable probability of reoccurrence of such a capital account crisis in the future, their past occurrence has certainly been fairly frequent. The staff undertook this analysis in the context of discussions with the authorities about their earlier interest in a Contingent Credit Line (CCL),

> which requires quantified stress simulators to be performed. We thought that it would be useful to make that analysis available to the Board in the context of the Article IV consultation report.

Mr. Brooke endorsed the remarks made by Mr. Kincaid and observed that the approach taken to sustainability analysis in the staff report was exemplary. The standard approach agreed in the earlier Board discussion on debt sustainability analysis reflected best current practice among Article IV consultation staff reports, but it did not necessarily represent the state of the art in sustainability analysis, and Directors had made a number of suggestions about further possible improvements. Such considerations notwithstanding, the application of the agreed approach in the case of Mexico was welcome, and the staff was encouraged to apply this general approach in all Article IV consultations.

The Acting Chair (Mr. Aninat) observed that part of the excellent preparation of the sustainability analysis in the staff report could also be due to the fact that Mexico had been planning to request a CCL at some point in the past.

Mr. Mirakhor wondered if all member countries should request a CCL to obtain such high quality staff reports.

Mr. Kudiwu made the following statement:

> Like previous speakers, we would like to commend the Mexican authorities for maintaining prudent fiscal and monetary policies in 2001, which contributed in keeping inflation at a low level. We welcome the indication of a rebound in economic activity in the second quarter of 2002, following the slowdown in 2001, and we are pleased to note that the external current account deficit narrowed and international reserves stood at a comfortable level. We also welcome the progress made in improving public sector debt management, which has declined from 42 percent of GDP in 1995 to 16 percent in 2001.
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> Although Mexico's economic prospects are broadly favorable, considerable risks remain that require careful consideration by the authorities. The staff paper highlights Mexico's institutional capacity to maintain prudent economic management and to react in an appropriate manner to adverse shocks. While this has contributed to improve the resiliency of the economy, we recognize, however, that Mexico was not spared by recent slowdown in the global economy, as evidenced by the downturn, which occurred in 2001. Therefore, like Mr. Shaalan and Mr. Sakr, we would like to encourage the authorities to continue managing their macroeconomic policy in a skillful manner and pressing ahead with structural reforms, while further reducing vulnerabilities. We also note that much still need to be done, in order to address the sizable regional disparities in growth, and to alleviate poverty, particularly in the rural sector.

Having said that, I will focus the rest of my comments on issues that deserve the particular attention of the authorities.

In the fiscal area, we welcome the actions taken in the context of the 2002 budget, and in particular, the allocation of additional resources to finance social expenditure and investment, as well as the introduction of adjustors. As regards the fiscal outcome during the first half of this year, it is worrisome to note that public sector revenue was below budget, owing to lower tax collections, namely income tax and VAT collections, which suffered from the lagged impact of weak economic activity. In the event, the authorities appropriately proceeded with cuts in outlays. However, this policy could affect the poverty alleviation efforts. Therefore, we share staff's recommendations for additional tax measures to achieve the medium-term fiscal targets without placing an excessive burden on expenditure control. We also concur with the view expressed in the preliminary statements of Ms. Lundsager and Mr. Ralyea, and Mr. Rustomjee on the need for further fiscal consolidation in 2003, in order to meet the medium-term objectives and maintain investor confidence.

As regards the monetary, it is encouraging to note that monetary policy stance is appropriate to achieve a decline in inflation. In this connection, we welcome the assurance given in Mr. Beauregard's introductory statement regarding the authorities' commitment to inflation targeting.

On trade sector, we commend the authorities for the progress achieved in trade liberalization during 2001 and for their continued commitment to multilateral agreements and active participation in the Doha Round of the WTO.

With regard to the medium-term program, we welcome the authorities' determination to carry out the structural reforms foreseen in the National Development Plan (NDP). These reforms, which put emphasis on the strengthening of external competitiveness and increasing productivity, will be critical in achieving higher economic growth. This could help increase job opportunities and reduce poverty. We commend the authorities for the high attention devoted to the comprehensive tax reform, so as to reduce the budget's dependency on oil-related revenue. The authorities' intention to proceed with reforms in the judiciary system, governance, energy sector and telecommunications, and labor market is a move in the right direction. It goes, however, without saying that gathering political consensus on the reform agenda will be essential to achieve these objectives. While staff is confident that achieving potential output growth of around 4 percent during 2003-06 is feasible, we would like to stress the need for the Mexican authorities to intensify efforts to move toward achieving a more broad based economic growth.

Finally, we encourage authorities to continue to maintain constructive relations with the private sector and to persevere in their position to avoid external arrears.

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

Mr. Bischofberger made the following statement:

I thank Staff for their thorough and in-depth analysis of the economic situation in Mexico as well as Mr. Oyarzábal and Mr. Beauregard for their comprehensive preliminary statement and Mr. Beauregard for his informative intervention at the start of this meeting. Mexico has continued to perform something of a "safe haven" role in an environment of worsened market sentiment and despite an economic downturn affecting its main trading partner. This is the pay-off of disciplined macroeconomic policies, significant improvements in the institutional framework, and a considerable strengthening of the financial sector in recent years. Like other speakers, we commend the authorities for these achievements, which have added a lot to policy credibility.

Going forward, the challenge will be to preserve this credibility. I note that Mexico's external and public debt projections display some measure of robustness even under less favorable assumptions. This is an encouraging result which, by the way, should promote further market discrimination, thus making a strong case for the publication of the Staff reports. That said, however, the well-known vulnerabilities should not be overlooked: the external financing requirements remain significant and the sizeable stock of public debt is still largely linked to short-term and floating interest rates. In addition, the corporate sector has become more vulnerable to adverse financing conditions.

Against this background, fiscal discipline will remain critical and the structural reform agenda will need to be broadened. With an election year coming up and possible signs of adjustment fatigue emerging, this will be every bit as demanding as the hard-won gains so far.

Having said that, I shall make a few remarks on fiscal and monetary policies, structural reforms, and the corporate sector:

On fiscal policy, the oil stabilization fund, the establishment of adjustors, as well as other ongoing improvements in the budget process are welcome and have greatly contributed to credibility. I encourage the authorities to further build on this progress by following up on the recommendations of the fiscal ROSC and the recent Fund technical assistance mission. Looking ahead to next year's budget, the discipline provided by the institutional framework may face another test. I agree that further sizeable reductions in the public sector borrowing requirement will be essential to reduce vulnerabilities and place public debt on a firmly sustainable path. It will be important in this context to raise the low non-oil related revenues both through improvements in tax administration and tax policy. However, further tax reforms do not seem likely to be passed next year. Under these circumstances, it is not quite clear how the necessary reduction in real primary expenditure would be achieved to meet the target.

Secondly, potential vulnerabilities emerging in the corporate sector should be closely monitored and I welcome the related analyses conducted by Staff as well as the assurances made by Mr. Oyarzábal on this issue. I do note, however, that the lack of information on corporate foreign exchange assets and on derivative operations raises the possibility that foreign exchange risks in this sector may be underestimated.

Thirdly, in order to support productivity growth, structural reforms need to be reinforced in such areas as the energy sector, the labor market, and governance. This will be vital to promote growth and the reduction of the still high incidence of poverty. It will also bolster external competitiveness after several years of sustained real exchange rate appreciation. At the same time, steps to liberalize regulated markets will be important to attract the continued high level of FDI needed to help finance the current account. In this regard, I take note of Mr. Kalter's comments on the prospects for passage of the important electricity bill and on labor market reforms envisaged to be implemented later this year.

On monetary policy, I agree with Mr. Kalter that the central bank's tightening of monetary policy seems to be appropriate given the information provided in the Staff update on a further up-tick in headline inflation and inflation expectations. It may not come as big surprise that as a former central banker, I welcome and support today's policy measure for the reasons given by Mr. Beauregard.

Finally, like Ms. Lundsager, we commend the authorities for their efforts to combat money-laundering and the financing of terrorism and we encourage them to follow through with their work on these areas.

To conclude, we wish the authorities further success in their endeavors to foster economic growth and reduce financial vulnerabilities.

Mr. Isleifsson made the following statement:

Let me first thank the staff for their interesting set of reports, not least the Selected Issues paper, and extensive answers to questions in this meeting.

I would also like to thank Mr. Oyarzábal and Mr. Beauregard for their comprehensive preliminary statement.

In spite of the slowdown in economic activity in 2001, the Mexican economy has remained resilient, and Mexico has largely managed to avoid the difficulties seen in other Latin American economies lately. This can largely be attributed to the strong economic policies and extensive reforms undertaken since 1995, as highlighted among others by Mr. Moser, Mr. Brooke and Mr. Bischofberger. Like Ms. Lundsager and Mr. Ralyea, and as emphasized by Mr. Mirakhor, I believe Mexico's favorable performance since 1995 provides a useful example for other countries. The favorable market sentiment toward Mexico, as documented by upgrades to investment grade status by the major rating agencies earlier this year, and the success of the recent 20-year bond issue, further testifies to the confidence created by the authorities' policies.

Notwithstanding the relatively favorable developments and the generally positive prospects for the Mexican economy, a number of risks remain. Mexico's sizeable external financing requirements make the country vulnerable to adverse shifts in market sentiment towards emerging market countries. I believe it is necessary to be steadfast in implementing the government's planned medium-term fiscal adjustment and the structural reform agenda, to maintain growth momentum and investor confidence. The strong trade links between Mexico and the United States also make Mexico vulnerable in the case of a prolonged slowdown in the U.S. economy. In this regard, I welcome the authorities' continued progress in trade liberalization, including the bilateral agreements signed with the EU and the EFTA countries.

Fiscal policy remains critical for Mexico. Like staff, I support the current policy mix, but note that the easing of the fiscal policy stance this year increases the need for adjustment in 2003 and the medium term. In the event of a further slowdown, the authorities should be prepared to implement additional expenditure cuts. I would also like to stress the importance of achieving the objective of strengthening the fiscal position significantly with an important reduction in the fiscal deficit and public debt by 2006. I believe this would greatly enhance market confidence. In this respect, it is reassuring to learn from the Selected Issues paper that the budget institutions and practices provide a stable framework for the execution of fiscal policies that is consistent with macroeconomic stability.

I welcome the authorities' continued efforts to increase revenue from improved tax administration. Measures to expand the taxpayer base and combat tax evasion will be important. However, as pointed out by staff, these measures may not be sufficient, and additional, more fundamental, measures to strengthen the non-oil revenue may be necessary to avoid placing an excessive burden on expenditure control.

Mexico has made substantial progress in reducing the risks associated with its public debt. The relatively large share of short-term and indexed domestic debt is, however, a source of vulnerability. Sizeable external financing requirements make the country vulnerable to adverse shifts in market sentiment. The authorities' measures to further improve public sector debt management by increasing the issuance of fixed-rate instruments and establishing benchmark issues in the domestic debt market are welcome, as they serve to reduce these vulnerabilities.

On monetary policy, I welcome the authorities' intention to formalize further the inflation-targeting framework. I would also like to compliment the authorities for their prudent management to achieve the inflation target and welcome the recent move to this effect announced by Mr. Beauregard in this meeting. While I understand that the present system of using the "corto" as a principal policy instrument has worked reasonably well, I do, however, agree with staff that switching to a regime with direct targeting of short-term interest rates might be advantageous from a transparency point of view and may, indeed, help to reduce volatility of interest rates.

The Selected Issues study on private sector financing in Mexico provides interesting information on developments since the Tequila crisis. It is clearly a key challenge for the banking sector to resume broad-based and sound lending to the private sector. The strengthening of the financial system in recent years will provide a good basis for increased credit growth when the economy recovers. It is also encouraging that the authorities are taking further steps to enhance the system's resilience. I support staff in encouraging the authorities to strengthen banking supervision further, with a goal of achieving full compliance with international standards.

Like other Directors, I was encouraged by the authorities' decision last year to publish the Article IV consultation report. I hope their decision will be the same this year, as I believe publication of this year's full set of papers will further enhance transparency and investor confidence in the Mexican economy.

In conclusion, I wish the authorities continued success.

Mr. Gallardo made the following statement:

We want to thank staff for a well-written set of papers on the Mexican economy, and Mr. Oyarzábal and Mr. Beauregard for their comprehensive preliminary statement. Despite solid economic policies and skillful macroeconomic management, the Mexican economy was affected by the slowdown in the world economy. In 2001, the United States was the destination of almost 90 percent of Mexico's exports and the source of some three-fourths of Mexican imports. This situation underscores the strong links between the Mexican and U.S. economies since the entry-into-force of NAFTA in 1994. The slowdown in the U.S. economy affected Mexico's economic growth in 2001, leading to a decline in real GDP after the strong real growth experienced in 2000. However, signs of a rebound in economic activity emerged in the second quarter of 2002, when the global index of economic activity grew at an average pace of 0.8 percent in April-May, and for 2002, economic growth is projected to reach 1.5 percent. The 12-month inflation rate slowed to 4.4 percent at end-2001, well under the target of 6.5 percent. While the 12-month headline inflation rate rose to 5.3 percent in August 2002 owing to increases in administered prices, core inflation continued to decline to 4.0 percent. The economic growth target for end-2002 is within reach, but inflation is expected to close 0.5 percent higher than projected.

We welcome the announcement made by the authorities to formalize further the inflation targeting framework adopted in 2001, by considering to adopt a long-term inflation objective, and the introduction of pre-established dates for the meeting of the BOM in order to enhance transparency of monetary policy and to improve communications with the markets. The BOM in its latest inflation report announced an inflation objective of 3 percent for 2004 and beyond with a band of plus/minus 1 percent. Upon the recommendation made by staff suggesting that direct targeting of interest rates would enhance transparency in the conduct of monetary policy and help to reduce volatility of interest rates, the authorities stated that, over the short run, the BOM will continue to use the "corto" as its principal policy instrument, given that it is well known and accepted by local markets. We defer to the authorities' judgment. The authorities face a difficult decision now that headline inflation is still high and inflationary expectations ticked upwards, but with core inflation declining and a large output gap, a situation that would normally allow for an easing of monetary policy. However, the authorities are rightly concerned in gaining credibility in the initial stage of their inflation-targeting framework. We support the authorities' commitment to continue implementing a prudent monetary policy with the objective to support economic stability.

Since 1995, when Mexico faced a systemic banking crisis, the health of the banking system has continued to improve. Notwithstanding the improved financial conditions of the banking system, real bank credit to the private sector declined the first five months of 2002, continuing the overall trend since the 1994–1995 economic crisis. Credit to the non-bank private sector declined from 62 percent of GDP in 1994 to 31 percent at end-2001. The composition of credit to the private sector has changed since the banking crisis unfolded. In 1994, banks participated with 73 percent of total credit whereas in 2001 its participation declined to 44 percent. The gap has been filled by external credit and nonbank institutions such as the pension and mutual funds. This diversification of the sources of financing indicates a welcome deepening of financial markets. The 2001 FSSA concluded that the financial system has improved its resilience to shocks in recent years and it is not likely to pose systemic problems.

The external sector remains in a strong position. The current account deficit for 2002 is expected to remain at 2.8 percent of GDP, about two-thirds, which is expected to be financed by foreign direct investment as has happened in recent years. The external debt is expected to remain at around 27 percent of GDP. Net international reserves increased by US$0.8 billion during the first half of 2002, following a gain of over US$9 billion in 2001. Gross international reserves amounted to more than US$45.5 billion at the end of June 2002, equivalent to 125 percent of short-term debt by residual maturity and 82 percent of annual gross external financing requirements.

The government has implemented a dynamic public sector debt management strategy that has resulted in lower cost of funding, longer maturities, and reduced external vulnerabilities. In the domestic debt market, the authorities have shifted toward issuing fixed-rate instruments with longer maturities, enabling an important increase in the average maturity and duration of its domestic debt. We welcome the strategy designed by the authorities to have in place an active liability management system to control the public debt.

Finally, we want to commend the authorities for their solid track record on the implementation of prudent economic policy and for strengthening the institutional basis toward maintaining economic and financial stability.

Mr. Al Azzaz made the following statement:

The Mexican economy's three-year upsurge and subsequent sharp weakening have largely tracked developments in the country's largest trading partner, the United States. The country's increased export orientation, openness, and integration into the global economy have made it more susceptible to developments abroad. The policy challenge now is to build on the economy's gains in the face of the adverse turn in the external environment. The priorities in that regard are well laid out in the staff's comprehensive and insightful report. Here, I will add a few brief remarks.

The staff notes that last year's recession in Mexico as the first in recent history not associated with a domestic economic crisis. While reflecting the considerable adjustments and reforms, this also highlights economy's continued vulnerability to external shocks. As the report details, a sharp deceleration in domestic demand was a major factor in transforming last year's externally induced slowdown into a recession. While welcoming the subsequent recovery in domestic demand, I share the staff's stress on addressing the economy's vulnerabilities.

The policy credibility of the authorities is evident from the continued high market grading of the Mexican sovereign debt. Regarding the corporate sector's high foreign debt, I am reassured by the explanation provided in the helpful preliminary statement by Mr. Oyarzábal and Mr. Beauregard. Vigilance to retain the strong market reputation is essential to both ensure growth and guard against contagion from crises in other emerging markets. In that connection, I broadly share the staff's views on management of the public debt, as detailed in the paper on Selected Issues.

For sustained growth, a lasting development of the internal market is a priority. To that end, the focus should remain on boosting productivity growth and ensuring a business friendly environment. I therefore welcome the long-term view of the National Development Plan. In that regard, Mexico's continued ability to draw external capital is a distinct advantage. Also, the high incidence of foreign direct investments reduces the volatility of these inflows. Against that background and given both continued macroeconomic prudence and the reforms outlined in Box 2, I share the staff's optimism on Mexico's potential to sustain faster growth and speedier reduction of poverty.

I welcome the authorities' priority for further deepening the domestic financial market. As detailed in Box 3, while the nonbank institutional investors now play a larger role, the domestic commercial banks have remained a relatively minor source of financing. I agree with the staff that prospects for domestic credit growth have improved in view of the improved institutional and legal framework. Further effort is needed, however, to strengthen the credit infrastructure, including the risk management capabilities of the domestic banks and institutional investors.

With these remarks, I wish the authorities further success.

Mr. Abel made the following statement:

Mexico's economy is arguably the strongest in Latin America, but that does not mean that things have improved as much as they were supposed to since the last crisis. The economy is not only affected by the global slowdown but the business sector is still gridlocked by corruption and bureaucratic meddling.

It is hard for most of Mexico's people to believe that the government can deliver on its promises. Half of the population still lives in households with monthly incomes under US$300. Although it is easy to open a store or launch a small business, such low incomes cannot support much retail growth or create jobs and willing taxpayers. Today only 7.3 percent of the population reports and pays income taxes.

Mexicans have seen too many broken promises in their lifetimes to expect much from a government that seems to create problems faster than it can solve them. But for all their burdens, the people are still willing to work hard in order to survive and better their lot.

The government is clearly well intentioned, and its policies are correct although the outcomes are disappointing. The country would reap more of NAFTA's benefits if it were possible to reform the legal order and the business environment along the lines of the reforms carried out in the countries preparing themselves for EU membership.

It is obvious what is missing. We wish the authorities every success in finding the missing pieces and effecting an institutional modernization on every front.

Mr. Boitreaud made the following statement:

At this stage of the discussion, I will try to summarize my comments, without developing the arguments for them as this has been done by previous speakers or in preliminary statements. There is also one point that I would like to emphasize more and that relates to the poverty reduction strategy.

First, I join Staff and others in commending the authorities for their management of the economy. The success is well illustrated by the fact that this recession was not due to domestic problems and that in spite of the decline in the GDP the financial equilibriums have been maintained. This is to the credit of the authorities and their policies.

Second, concerning monetary policy, we thank Mr. Beauregard for his explanation on the recent decision of the central bank. Reading the report, before this decision was made, we found the monetary policy appropriate, notably given the decline in core inflation. We however understand the reasons behind the recent move and the authorities' closed attention to the credibility of their inflation targets. So, we just hope that this decision will not have an adverse side effect on the exchange rate and on growth.

Third, the fiscal situation and debt management remain broadly satisfactory; however, I agree with Staff and the authorities that further improvements remain to be done. The debt situation has markedly improved and the generally sound policies followed by Mexico have increased the country's ability to weather external shocks. The strength of the country's financial situation is reflected in its good rating and the low level of the risk premium, as underlined by Mr. Isleifsson and others. Nevertheless, we have recently seen how fast rating agencies can change their minds and also how versatile the market can be. In that regard, we share Staff's view that the exposure to short-term debt and floating interest rates as well as the large gross Public Sector Borrowing Requirement constitute significant vulnerabilities. We have noted Mr. Beauregard's explanations on the difficulty to lengthen the debt's maturity but, still, we believe that debt management can be further improved. Furthermore, we agree that the non-oil tax revenue should be increased and we encourage the authorities in their efforts to secure the adoption and the implementation of their tax reform package.

Fourth, the poverty situation in Mexico remains a source of concern and we welcome the authorities' medium- term plan to address this issue, as described by Mr. Kalter. Staff quotes the World Bank's country assistance strategy (CAS) that emphasizes that growth is the most important determinant of poverty reduction in Mexico. This is true, and I agree with Ms. Lundsager and Mr. Ralyea that this is certainly true in other countries as well. But it is worth mentioning that many directors in the Bank's board underscored that growth is necessary but not sufficient and other countries with the same level of GDP per capita have a less unequal distribution of income and I would appreciate if the staff could indicate how poverty statistics in Mexico compare with statistics in countries with similar GDP par capita ratio. Thus, addressing regional disparities, as underlined by Mr. Lombardi and others, addressing urban rural inequalities as well as gender issues could certainly improve Mexico's performance in terms of poverty reduction. This can be done without damaging growth, and maybe have the opposite effect: better social cohesion often goes with better security and a better climate for the whole economy.

With these comments, I wish the authorities further success.

The staff representative from the Western Hemisphere Department (Mr. Kalter) observed that he would respond bilaterally to Mr. Boitreaud's question regarding the comparability of poverty indicators in countries with similar income levels, as he did not have those statistics available for the current Board discussion. More generally, while economic growth was certainly not sufficient to reduce poverty, it was a necessary condition, as indicated by the changing poverty levels in Mexico during periods of economic growth and in times of crisis—there had been a huge increase in poverty after the 1994–1995 crisis and a significant improvement in poverty indicators in the following period.

Mr. Beauregard made the following concluding remarks:

Directors have recognized that progress has been achieved so far in addressing Mexico's vulnerabilities. As noted in my preliminary statement, there are still vulnerabilities, but important progress has been achieved. The recognition that these efforts take time to mature is also important. Once again, I would like to emphasize my authorities' commitment to continue reducing these vulnerabilities.

To conclude, I thank all Directors for their helpful comments, which I will convey in full to my authorities. Many Directors have underlined that these results are not an accident but the result of the authorities' commitment to the reform process and to sound economic policies. It has not been easy and not only the authorities are to be commended, but also all Mexicans, as they have, in some cases, seen less progress than the once promised, but they have nevertheless supported the needed changes to allow Mexico to advance in this globalized era.

There is yet another actor that has played a very important role in this process, which has not been mentioned in the current Board discussion. I am referring to the Fund. Its policy advice throughout all these years has been key to explain where we stand today. In particular, I want to stress the high appreciation of my authorities for the staff, which, as recognized by Directors, has done an outstanding job. The discussions held with the authorities were frank. Sometimes there was agreement, sometimes there was not, but what is important is that the debate has always been fruitful.

The Acting Chair (Mr. Aninat) made the following summing up:

Directors commended the authorities for maintaining prudent fiscal and monetary policies in the face of weak economic activity. As a result, inflation has declined, the external current account deficit is moderating, and international reserves have strengthened significantly. Directors noted that last year's recession was the first in Mexico's recent history not associated with a domestic economic crisis—demonstrating a resilience that distinguishes the country as a relatively "safe haven" among emerging markets.

Directors observed that the difficult external environment had weakened Mexico's economic performance in 2001, but that growth has begun to rebound this year in line with the pick up in activity in the United States. Continued skillful macroeconomic management and strong focus on trade, as well as further progress in structural reforms, will be essential for achieving faster growth and continuing to reduce poverty.

Directors welcomed the authorities' medium-term economic program (PRONAFIDE), which centers on structural reforms aimed at strengthening further the fiscal position, enhancing competitiveness and increasing productivity. Full implementation of the reforms is now essential to place the economy on a higher growth path that would facilitate poverty reduction. Directors emphasized the particular importance of reforms in the tax system to reduce reliance on oil revenues, as well as in the energy and telecom sectors, the labor market, and the judicial system, including improvements in governance.

Directors welcomed the authorities' commitment to a fiscal framework aimed at a sizable reduction in the fiscal deficit and public debt by 2006. They stressed that successfully implementing the authorities' objective of a front-loaded fiscal adjustment in 2003 would be important to further enhance Mexico's market credibility, following the easing of the fiscal policy stance this year. Achieving this objective would also reduce pressure on real interest rates, allowing room for increased private sector activity, and raising Mexico's resilience against external shocks.

In considering the mix of adjustment measures, Directors noted the authorities' firm commitment to curtail spending as needed to achieve the medium term fiscal targets. They welcomed the fact that, despite the tight spending constraints, the authorities had increased social expenditures markedly in recent years, which had led to an improvement in poverty indicators. Directors supported the authorities' intention to continue to build support for the much-needed second stage of fiscal reforms, especially the harmonization of the VAT rates, and commended the authorities' continued efforts to improve tax administration.

Directors welcomed the main findings of the fiscal ROSC mission, namely, that the government has made considerable progress in improving transparency and complying with international standards. Major initiatives included reforms to the budgetary process, timely disclosure of fiscal information, and strengthening of internal controls. The recent publication of the fiscal ROSC is an important example of this progress. Nevertheless, Directors noted that additional actions are still needed, including a redefinition of the institutional coverage of government, and presentation of the budget within a medium term context.

Directors noted that Mexico's central bank has gained considerable credibility in recent years in the conduct of monetary policy. In light of the recent uptick in inflation expectations and the turbulence in international markets, they endorsed the bank's monetary policy stance, including today's tightening of policies, as appropriately geared toward achieving a decline in inflation to low levels. An easing of monetary conditions could be considered at a later stage should prospects for economic recovery weaken, and provided inflationary expectations are successfully reduced.

Directors welcomed the authorities' intention to strengthen further the inflation targeting framework, and the announced adoption of a long-term inflation objective for 2004 and beyond. Most agreed that the "corto" continues to be a flexible and efficient monetary policy instrument that allows for appropriate adjustments in interest rates. Moving forward, some Directors saw merit in considering a shift toward the direct targeting of short-term interest rates as a means of further enhancing transparency in monetary policy—especially in a strengthened inflation targeting framework—and reducing interest rate volatility, while others noted that such a move could increase volatility in the exchange rate.

Directors welcomed the continued strengthening of the financial system, and the additional measures that are being introduced, aimed at achieving international standards. In particular, they noted the measures to reduce the Bank of Mexico's credit risk associated with the payments system, and the recent legislation to modernize the state-owned development banks. Some Directors expressed concern about the stagnation in bank credit to the private sector, but took note of the authorities' expectation that a resumption in lending could be facilitated by the reforms introduced to improve the credit infrastructure, including the framework for creditor rights, and to strengthen bank supervision.

Directors viewed the present level of international reserves as broadly adequate in the context of a flexible exchange rate regime, noting that reserves more than fully cover short-term debt. A few Directors felt that a further accumulation of reserves would be desirable to provide an extra margin of safety. As regards external competitiveness, several Directors observed that the timely implementation of productivity enhancing measures as proposed by the authorities would help allay possible concerns about the appreciation of the real exchange rate in recent years, although it was noted that Mexican exports continue to gain market share in the United States, its main trading partner.

Looking ahead, Directors noted that despite favorable economic prospects uncertainties remain, including the strength of the recovery in the United States, volatility in equity markets, and the weakening of sentiment toward other emerging market economies. In addition, a number of Directors pointed to the risks related to the large public sector financing requirement, and the structure of public and corporate debt, and cautioned that delays in implementing the authorities' medium-term fiscal adjustment and structural reform agenda could increase the economy's vulnerability and lower growth prospects. In this context, Directors took note of the results of the stress simulations that suggest that the external sector could weather well a potential sizable capital account crisis. They welcomed the authorities' efforts to further improve public debt management through continued issues of long-term fixed-rate instruments, and by establishing benchmarks in the domestic debt market. They also welcomed the authorities' intention to undertake a World Bank-led ROSC on corporate governance, and encouraged them to continue their close monitoring of the corporate sector. In general, Directors were reassured by the authorities' well-deserved reputation for addressing adverse circumstances through prudent economic management, and by the measures that have been taken to strengthen the institutional basis for maintaining economic and financial stability.

Directors noted that Mexico's data are generally of good quality, timely, and adequate for conducting surveillance effectively.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/02/99 (9/20/02) and EBM/02/100 (9/23/02).

5. GUYANA—POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT; AND ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—ADDITIONAL INTERIM ASSISTANCE

1. The Fund determines that the World Bank has concluded that the Poverty Reduction and Growth Strategy Paper submitted by Guyana (set forth in EBD/02/133, 8/30/02) provides a sound basis for World Bank concessional financial assistance.

2. Accordingly, the Fund's decisions set forth in EBS/02/167, Sup.1 (9/20/02), shall become effective on the date of this decision.
(EBS/02/167, Sup. 1, 9/20/02)

Decision No. 12859-(02/100), adopted
September 20, 2002

6. RELATIONS WITH WORLD TRADE ORGANIZATION (WTO)—INVITATION TO ATTEND COMMITTEE ON LIAISON WITH WTO MEETING

The Executive Directors agreed to invite the WTO Secretariat to send an observer to attend the upcoming meeting of the Committee on Liaison with the WTO, tentatively scheduled for October 8, 2002.

Adopted September 20, 2002

7. APPROVAL OF MINUTES

The minutes of Executive Board meeting 02/74 are approved.

APPROVAL: January 3, 2003

SHAILENDRA J. ANJARIA
Secretary