October 5, 2001
Approval: 10/12/01

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 01/32

9:45 a.m., March 30, 2001

Contents

Executive Board Attendance

H. Köhler, Chairman
S. Fischer, First Deputy Managing Director
E. Aninat, Acting Chairman

Executive Directors	Alternate Executive Directors
S.M. Al-Turki	A.S. Alosaimi
A. Barro Chambrier	D. Ondo Mañe
	J.A. Chelsky, Temporary
	D.C. Guinigundo
	F. Zurbrügg, Temporary
	W.-D. Donecker
	C.A.E. Sdralevich, Temporary
D.I. Djojosobroto	Low K.M.
V.L. Kelkar	R.A. Jayatissa
W. Kiekens	
O.-P. Lehmussaari	
	M. Lundsager
J.-C. Milleron	G. Bauche
	I. Mateos y Lago, Temporary
A. Mirakhor	
	A. Lushin
H. Oyarzábal	F. Varela
	S.P. Collins
M. Portugal	R. Junguito
	J. Milton
A.S. Shaalan	A.F. Al-Faris
Wei Benhua	Jin Qi
J. de Beaufort Wijnholds	
Y. Yoshimura	H. Toyama
A.G. Zoccali	G.R. Le Fort

S.J. Anjaria, Secretary
A. Mountford, Acting Secretary
S.T. Djumena, Assistant
M. Schulte, Assistant

Also Present

IBRD: I. Haq, Office of the Executive Director; Z. Allaoua, J. Panzer, M. Peñalver, South East Asia Region Office; A. Shakow, Development Committee. External Relations Department: T.C. Dawson, Director; R. Chote, W.J. Murray. Fiscal Affairs Department: G. Taube. IMF Institute: M.S. Khan. Legal Department: S.C. Ho, B. Steinki. Middle Eastern Department: P. Chabrier, Director; S. Eken, K. Enders, T.F. Helbling, A. Jbili, J. Le Dem, K. Nashashibi, G. Shabsigh. Monetary and Exchange Affairs Department: M.B. O'Brien. Policy Development and Review Department: M. Ahmed, Deputy Director; C. Christofides, R. Glennerster, M.T. Hadjimichael, Y. Metzgen, M. Ronci. Research Department: M. Mussa, Economic Counsellor and Director; A.M. Hussain, P.R. Masson, A. Spilimbergo. Secretary's Department: S. Bhatia, P. Gotur, A. Mountford, P. Ramlogan. Western Hemisphere Department: O. Melhado. Office of the Managing Director: C. Salmon, Personal Assistant; A. Bauer, S.B. Brown, R. Sahay. Advisors to Executive Directors: J.M. Abbott, M.A. Ahmed, E. Azoulay, M. Beauregard, W.-D. Cho, S.S. Farid, N. Guetat, O.A. Hendrick, O. Himani, A.R. Ismael, M. Kabedi-Mbuyi, Liu F., M.F. Melhem, J. Ntamatungiro, Y. Patel, G. Schlitzer, M.R. Shojaeddini, I. Steinbuka, R. Villavicencio, R. von Kleist, M. Yanase. Assistants to Executive Directors: P.A. Brukoff, N. Burnashev, N.J. Davidson, T. Hadded, F. Haupt, C. Josz, S.K. Keshava, R. Manivat, P.A. Nijsse, Y. Saito, J. Sigurgeirsson, Sugeng, D. Taylor, S. Vtyurina, M. Walsh, D.B. Waluyo, A.Y.T. Wong.

1. PAKISTAN—STAND-BY ARRANGEMENT—REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered a staff paper on the first review under the Stand-By Arrangement for Pakistan and its request for waiver and modification of performance criteria (EBS/01/39, 3/19/01).

The staff representative from the Middle Eastern Department (Ms. Eken) submitted the following statement:

> This statement reports on the implementation of prior actions that have been specified in the Memorandum on Financial and Economic Policies (MEFP) and provides an update on the main recent economic developments and financing issues. The information contained in the statement does not alter the analysis and appraisal contained in the staff report (EBS/01/39).
>
> The two remaining prior actions at the time of the circulation of the staff report to the Board have been implemented. Increases in the average electricity tariff rates of the Water and Power Development Authorities (WAPDA) and of the Karachi Electricity Supply Corporation (KESC) of 4.5 percent and 13.2 percent, respectively, were approved by the National Electric Power Regulatory Authority (NEPRA) in decisions dated March 18, March 22, and March 24 and became effective on March 27, 2000. In addition, formula-based automatic fuel price adjustment clauses for electricity tariffs were introduced.
>
> Official reserves are improving without undue pressure on the rupee. As of March 28, the level of usable gross official reserves amounted to US$735 million. The buildup of reserves over the last month (from US$566 million at end-February) was mainly achieved through purchases of foreign exchange in both interbank and kerb markets, without any recourse to short-term swap and forward contracts. The rupee has depreciated by 0.7 percent since the beginning of the month, and the spread between the interbank and kerb rates remains at about 5 percent.
>
> Monetary policy stance has been tightened. To mitigate the pressure on the exchange rate from the foreign exchange purchases and to meet the NDA target of the State Bank of Pakistan for end-March, the Central Bank has started to mop up rupee liquidity and raised interest rates on March 21. Treasury bill rates have risen by 32–65 basis points. With the parallel loosening of the U.S. Federal Reserve's monetary policy stance, the spread in favor of the rupee has increased even more. At 11.3 percent, the rate on three-month Treasury bills is now above the comparable U.S. rate by more than 700 basis points, against 430 points in November 2000.

> The Central Board of Revenue (CBR) has continued to implement the short-term action plan to improve tax administration broadly as scheduled. Over the past few weeks, the authorities have focused especially on sales tax audits, arrears, and nonfilers. In particular, the CBR has increased the number of sales tax audits to 620 in February (from a monthly average of 240 during July–December 2000 and 510 in January 2001); reassigned 400 auditors from tax survey work to sales tax audits; and stepped up supervision of auditing and follow-up on nonfilers in collectorates. In addition, effective March 15, the establishment of Appellate Tribunal benches has been simplified to allow more and faster hearings of sales tax arrears cases. The final report of the Committee to Revise the Income Tax Ordinance has been submitted to the government by end-March as scheduled, and the authorities have requested further technical assistance from LEG and FAD with the objective to have the new income tax ordinance ready for promulgation with the 2001/02 budget in July. The submission of the final report of the Task Force on Tax Administration has been delayed until mid-April.
>
> The SBP has approved a further cut in subsidies under the Export Finance Scheme (EFS) and withdrawn the restriction on commercial banks' placement of foreign currency deposits abroad, effective April 1. EFS rates will increase from 9 percent per annum to 10.5 percent; the authorities intend to eliminate the remaining EFS subsidies by end-June 2001. The SBP has put in place a reserve requirement of 25 percent on foreign currency deposits, as well as other measures to protect the interest of depositors, as envisaged in the MEFP.
>
> The mobilization of exceptional financing is proceeding as envisaged in the MEFP. All the prior actions required by the Asian Development Bank related to two loans have been implemented, and US$80 million is expected to be disbursed shortly. Preparation for the World Bank's Structural Adjustment Credit (SAC) is under way. Drafts of the President's Report and of the Country Assistance Strategy Update are under review by the World Bank's Operation Committee. The US$350 million credit is expected to be considered by the Executive Board of the World Bank by end-May 2001.

Extending her remarks, the staff representative from the Middle Eastern Department said that the authorities had informed the staff that the decision regarding the extension of GST to urea had been taken by the prime minister. The related documentation had been signed by the prime minister but was awaiting the signature of the president. Therefore, no formal announcement by the staff had been made.

Mr. Mirakhor submitted the following statement:

> Our authorities wish to thank the staff for a clear and well-written report and concur with the broad thrust of their appraisal and policy recommendations. Despite the intensification of drought conditions and an

external environment that is becoming more difficult as export unit values fall amid a generalized slowing of external demand, economic performance in Pakistan during the first six months (July–December 2000) offers grounds for cautious optimism. While the setback to the agricultural sector stemming from the drought hurt overall GDP growth, the industrial upswing gathered strength, inflation performance was better than expected, the underlying current account position was broadly in line with program projections, and gross official reserves rose to more comfortable levels—a shortfall in capital inflows and official assistance notwithstanding. More importantly, fiscal adjustment, which is seen by the authorities as the anchor of the program and crucial to the task of achieving macroeconomic stability and external adjustment, was better than programmed with an overperformance equivalent to 0.7 percent of GDP.

Good progress was also achieved on the structural side. The IPP issue was settled: The long, drawn-out tariff dispute between the Water and Power Development Authority (WAPDA) and the Hub Power Company (HUBCO) was finally resolved in a manner satisfactory to both parties; new medium- and long-term bonds (the Pakistan Investment Bonds) were issued on schedule; the restructuring of the financial sector continued; and the authorities made further headway on their governance agenda, especially with regard to the drive to improve the reporting of public finances.

There were, however, some less propitious developments. The authorities' wide-ranging and unprecedented tax registration and documentation drive did not produce the quick results they had expected. Tax revenues fell short of the very ambitious target, but this shortfall was more than offset by expenditure cuts to protect the target for the fiscal deficit. The task of monetary policy was complicated by an unanticipated surge in the demand for currency and credit to the private sector. As a consequence, meeting the very tight end-December performance criteria required some drastic and unconventional steps.

Looking at the overall economic performance in the first six months under the SBA, the authorities believe that Pakistan is off to a good start in implementing its adjustment and reform agenda despite the challenges posed by adverse exogenous developments. To be sure, as staff note, lower growth and shortfalls in external financing have weakened macroeconomic prospects. Nevertheless, there are still a number of positive developments which, taken together, suggest that Pakistan will succeed in meeting program objectives. A momentum has been built up in the structural reform area, and it will gather strength in the period ahead, setting the foundation for higher growth and poverty alleviation over the medium term.

Fiscal policy will remain on track with an unchanged deficit target for the year. The revenue target for the year has been lowered in recognition of earlier shortfalls, but the target—while still ambitious—is realistic. To preclude further shortfalls, the authorities are implementing a short-term action plan—the elements of which are well described in the staff report and the attachment to the MEFP—for improving tax administration that is based on recommendations of FAD. Total expenditure has also been reduced, mainly through cuts in low-priority development spending. The authorities are concerned with the shortfall in social and poverty-related spending in the first half of the year, although much of this shortfall may actually reflect a more cautious attitude to spending in line with relevant ministries/departments in the context of the emphasis on improved accountability and governance.

Monetary policy has been tightened with two recent increases in interest rates to protect the external sector and to keep inflationary pressures at bay. The authorities recognize that the external reserves, while improving, are still at a low level, which calls for vigilance and prompt action should the situation warrant. The exchange rate has been, and will continue to be, managed flexibly as the authorities discontinue sales of foreign exchange in the interbank market to finance oil imports and gradually phase-out purchases from the kerb market. The revised monetary program takes into account the more permanent nature of high demand for rupee cash and, accordingly, envisages a gentler deceleration in reserve money growth. It will, however, still entail a considerable tightening in monetary policy compared with the end-January period.

The structural reform agenda is comprehensive and demanding. It envisages further tax, energy, financial sector, and governance reforms. In the tax area, the authorities remain committed to extending the GST to the retail sector and agricultural inputs, a major reworking of the income tax, a meaningful agricultural income tax, and a plan to reform tax administration. These reforms will durably strengthen the fiscal position and make room for urgently needed spending on physical infrastructure and social and poverty-related programs. Steps are being taken to improve the financial position of WAPDA and the Karachi Electric Supply Corporation (KESC), including, as a prior action, an adjustment in their tariffs. KESC is to be restructured with the assistance of the Asian Development Bank (ADB). The World Bank is preparing a Structural Adjustment Credit (SAC), which will focus on governance, growth, and human resource development issues. The Bank is considering a further operation in support of the planned reforms in the financial sector, which, inter alia, will entail major labor shedding and liquidation and/or mergers of a number of development financial institutions.

As the staff report clearly brings out, improving governance is a theme that runs through virtually all the government's reform agenda. This is a multifaceted task, and the staff report describes well the scope and breadth of this effort. The government's devolution plan, which is anchored on greater accountability and delivery of services, is proceeding well and with due recognition of the challenges it may pose for fiscal management. Good progress also continues to be made on data-related issues, although the authorities recognize that the accounts reconciliation and reporting process in the provinces need to be strengthened further.

The staff report suggests that there remain "significant risks" to achieving program objectives. Clearly, if domestic and external shocks intensify, the risk of not meeting key program objectives will rise—as it would in any program that is buffeted by unanticipated adverse events. Barring that gloomy scenario, however, the authorities are confident that they are up to the challenges confronting them and that the known risks are manageable. At the same time, they recognize that this review constitutes only one small step on the long and arduous road of adjustment and reform and that the benefits of their reform actions in terms of improvements in the lives of the people of Pakistan will be felt only slowly. Nevertheless, their commitment to continue along the path of reform remains undiminished, and they look forward to the Executive Board's discussion and advice, as well as its support for an early negotiation on a program that can be supported by the PRGF.

As before, the Pakistan authorities have agreed to the full release and publication of the LOI/MEFP, as well as the staff report.

Extending his remarks, Mr. Mirakhor stressed that the authorities would do all they could to ensure an orderly transition to Islamic banking. There would be minimal disruption or no disruption at all, either in the operations of the financial system or in the payment system. It was important to note that the Supreme Court had ruled that all external financial operations were exempt from the purview of the transition toward Islamic banking and Islamic finance.

Shortfalls in poverty-related spending were not a consequence of expenditure cuts, Mr. Mirakhor stated. Spending cuts were concentrated on low-priority development projects, and the shortfalls were related to greater caution on the part of spending ministries because of the ongoing drive to improve accountability and governance at all levels of government.

On exchange rate policy, the Central Bank had been completely transparent in its recent operations, Mr. Mirakhor said. Foreign exchange had not been sold to finance lumpy oil payments, and the determination of the exchange rate had been left to market forces. This was reflected in the steady depreciation of the rupee. On swaps, as the staff update noted, the buildup in reserves had taken place without recourse to short-term swaps.

With regard to Mr. Collins' question on GST exemptions, information had been received earlier that the GST exemptions on urea and pesticides had been removed, so they were now subject to GST, Mr. Mirakhor noted.

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

Pakistan has made welcome progress under the Stand-By Arrangement approved last November. The improvement in the external position was better than initially expected, and progress was also made in strengthening the fiscal position and in containing inflation. Although these developments have been encouraging, a number of weaknesses have become apparent during the past few months. In particular, weaknesses in tax administration continue to highlight the fragility of the fiscal outlook. Furthermore, the external environment remains highly susceptible to external developments, as evidenced by the bouts of pressure on the currency and the weaker than expected foreign investment.

Taken together, the macroeconomic developments in Pakistan over the past few months serve to underscore the importance of steadfast implementation of measures agreed under the Fund program. In this regard, it is worth noting that adherence to the spirit of the program is as important as adherence to the letter of the agreement.

The fiscal measures envisaged under the program are geared towards a multiplicity of objectives. In addition to macroeconomic stabilization, the authorities are seeking to introduce a less distortionary tax system, while also devolving certain fiscal responsibilities to local authorities with the objective of enhancing governance. This agenda is both ambitious and complex, and will require continuous and careful monitoring of fiscal developments and effecting policy changes that may be required during the implementation period.

The overall fiscal stance, as measured by the size of the fiscal deficit, is appropriate at this time. However, revenue developments have fallen short of expectations, and the authorities have appropriately responded by reining in expenditures. Thus, while fiscal developments meet the immediate requirements of macroeconomic stability, they fall short of satisfying the medium- to long-term needs of the economy. The expenditure priorities that the authorities have set for them can only be achieved through the successful completion of the revenue and tax administration measures that are envisaged.

The revenue-related measures envisaged under the program form a sound and comprehensive reform agenda that, when fully implemented, should form the basis of a much more robust and efficient tax system. Furthermore, as the authorities have placed the improvement of governance as one of the pillars of their reform agenda, the devolution of power to local authorities promises to make an important contribution in this area by strengthening accountability. However, as the staff recognize, the devolution of power also poses risks to fiscal management, and hence to the macroeconomic outlook. Thus, while the devolution plan is important, particularly for the medium- to longer-term fiscal position, care needs to be taken to ensure that its implementation does not pose undue risks to the near-term fiscal outlook. We therefore support the staff's recommendations regarding the completion of the preparatory work for the devolution plan at an early date.

A fiscal stance that is based on a stronger underlying revenue position should help reduce overall macroeconomic uncertainties, and thereby facilitate the task of monetary management. At the present time, the constellation of the external position, low level of reserves, and uncertainties regarding the cash demand for rupees render the task of the monetary authorities particularly difficult. Furthermore, although the authorities have been able to meet the monetary targets agreed under the program, the underlying monetary stance was weaker than intended, which in turn necessitates a significant tightening of the monetary stance. Against this background, we are encouraged by the pragmatic approach to monetary management envisaged under the program. The authorities' readiness to make timely and appropriate adjustments in interest rates and open-market operations to ensure that the monetary stance remains sufficiently tight will be key to the program's success.

The medium- to long-term outlook for the economy also depends on the implementation of broad-based structural reforms. Here, the outstanding agenda of reforms facing the authorities is daunting by most standards, but we are very encouraged by the momentum for reform that has been built up in the area, as noted in Mr. Mirakhor and Mr. Ahmed's helpful preliminary statement. Looking ahead, we would place particular emphasis on financial sector reforms, in order to put in place a stronger and more efficient banking system that is better equipped to serve the economy's financing needs.

In sum, we share the staff's view that there are significant risks to achieving the program objectives. We also feel that the potential rewards from the successful completion of this program are very high, both directly through its impact on the macroeconomic environment, and indirectly by strengthening confidence in Pakistan's economy. We wish the authorities every success in the period ahead.

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

First, we would like to thank staff for a well-written report, and Mr. Mirakhor for his helpful preliminary statement.

We think that adjusting the growth projection for 2001 downward to 3.8 percent from 4.5 percent is reasonable given the effect of the drought on the agricultural sector and the importance of that sector to the economy. The economy must achieve stronger growth, however, if poverty is to be reduced, especially in view of the expected 2.4 percent a year growth in population. This makes it even more important to ensure that the SBA-supported economic program is sufficiently strong, and to achieve the necessary stability for sustainable strong growth.

Undoubtedly, the most crucial element in this SBA-supported program is revenue strengthening. According to the projection for 2000/01, 42 percent of revenues is to be allocated to interest payments and 28 percent to military expenditure, which leaves little for necessary public services. In order to break the vicious circle of weak tax compliance and weak revenue leading to insufficient public services, which in turn leads to weak tax compliance and weak revenue, the necessity to strengthen revenue cannot be overstated. It is indeed remarkable that revenue collection increased by 13 percent. Nevertheless, the slippage in the end-December target is disappointing, and the even greater slippage in January and February is worrying. We can go along with the modification of the Central Board of Revenue (CBR) targets for end-March; however, we urge the authorities to make their utmost efforts to meet the "realistic" revenue targets. On the other hand, although the revenue targets were not quite met, we commend the steady efforts of the authorities in implementing various reforms, as also noted by the staff. Concerning the tax registration drive, we have heard that there has been a 30 percent increase in the number of registrations by shop owners for the sales tax. We also welcome the Short-Term Action Plan, which can be implemented within the limited time frame of the present 10-month program. This shows the authorities' determination to handle the problems underlying the CBR.

To compensate for the shortfall in revenue, we recognize that further expenditure cuts are expected in order to meet the budget deficit target. Looking at the pattern of expenditure restraint, we see that cutting development expenditure during the course of the fiscal year has been done in the past. We are concerned that the considerable decrease in development spending over past years has acted, and could continue to act, as an impediment to growth. It would be desirable to further overhaul current expenditure and cut the level of spending. We note that "better enforcement of accountability and governance standards" is mentioned as a reason for lower spending at the provincial level on social areas and poverty alleviation. Fiscal management at the provincial level will become increasingly important in the provision of social services, and careful attention needs to be paid to the development of the devolution issue. In this context, we found the information in Appendix II very useful.

On monetary policy, we support the staff's position on the tightening stance to support the accumulation of reserves. Although inflation seems to be subdued at present, careful attention needs to be paid to the effect of the depreciation of the rupee on prices as well as to the effect of the growth of demand for cash on inflation.

When the issue of Islamic banking was raised at the previous Board meeting, staff merely mentioned that the principles were still being discussed and would be put into effect gradually. Four months later, there still seems to be no clear picture of what the rules of the system will be and how the system will operate in practice. This only adds to the uncertainty and worries of potential investors. It would be helpful to know about recent developments and the staff's views on this issue.

Structural reform cannot be completed within a period as short as the present SBA, and it is important that continuous efforts are made. The staff mentions the sustainability of reform efforts, and it is vital that the momentum is kept and that a foundation for continuous implementation and a follow-up system is prepared in the period leading up to and beyond the fall 2002 elections.

The report does not discuss how to strengthen Pakistan's exports through diversification, and the projection on export growth seems too simplistic. In the present situation, 75 percent of Pakistan's exports will be cotton products, which are low value-added, vulnerable to demand and supply shocks, and do not offer much room for growth. We would appreciate it if staff could elaborate on any discussion they may have had with the authorities on export diversification and strengthening of the export base.

At the recently held Pakistan Development Forum, the government requested further assistance from the international community. To gain the confidence of the international community, self-help efforts are very important, and in this respect we welcome that the authorities did not request debt reduction, saying they would repay their debt by means of income gained through economic growth. We welcome the recent agreement with Paris Club creditors on the framework of rescheduling and look forward to progress in the bilateral negotiations. Also, on the debt front, we welcome that the authorities are preparing a report on debt restructuring and reduction strategy. This shows their intention to address the problem and search for an exit strategy in a serious manner.

We commend the authorities for the steps they have taken to implement the policies supported by the present SBA. That said, looking at the table on external financing requirements, we see that large financing gaps—\$2 billion in 2001–02, \$1.7 billion in 2002–03, and \$1.3 billion in 2003–04—are foreseen. These numbers show that the present program supported by the SBA can only address short-term problems, and that the authorities must be fully aware of, and face, the harsh reality of their heavy debt burden in the medium to long term. For the Pakistani economy to move to a sustainable growth path, implementation of the presently suggested policies is only the first step. What is essential is for the authorities to implement measures that will comprehensively restructure the economy in the long run, with even stronger ownership. In order to achieve this, needless to say, ensuring transparency and improving governance will make the economy more efficient, and also will be an important factor in attracting potential domestic and foreign investors. In addition, as the authorities themselves point out in their report on debt strategy, it is important that debt sustainability is secured through the implementation of a medium-term economic program. Concerning the financing gap, we would note that this should be filled in such a way as to ensure fair burden sharing among creditors. The authorities should not rely excessively on the rescheduling of present debt to bilateral donors but should consider, for example, implementing other measures so as to secure further assistance from IFIs. In light of this reality, it is important for the authorities not to be complacent about the results achieved but to keep the momentum going and continue to tackle the deep-rooted problems in the economy.

With these remarks, we support the completion of the first review, as well as the waiver and modification of the performance criteria. We wish the authorities the best in their future endeavors.

Mr. Junguito submitted the following statement:

We would like to thank the staff for an informative report and Mr. Mirakhor and Mr. Ahmed for their substantive preliminary statement.

The Pakistani authorities are to be commended for the better than envisaged economic performance under the program with regard to inflation, the fiscal position, and the external account position. Economic growth, even though it was lower than projected, continued to be strong, despite the adverse impact of weather or agricultural output. We also welcome that all quantitative criteria, except for that of the Central Board of Revenue (CBR), were met at end-December. In sum, we share Mr. Mirakhor and Mr. Ahmed's view that recent economic performance offers grounds for cautious optimism.

On the fiscal front, we take note that fiscal revenue targets are reduced, but welcome the fact that they remain appropriately ambitious and that, in order to prevent an increase in the deficit, the target for total expenditures was reduced by a similar amount. The cut of expenditures is centered on lower-priority projects. Notwithstanding, we share the staff concern that poverty-reducing expenditures could be adversely affected. We support the authorities' decision to extend the GST, the overhaul of the income tax, and the reform of the tax administration. Such measures will help to achieve medium-term fiscal sustainability.

Appendix II on the Devolution Initiative and Provincial Public Finances sets out the immense but important challenge that Pakistani authorities face in their road towards fiscal decentralization. We generally support the view that the efficiency of public expenditures increases when decisions are made at the local level, and that expenditure responsibilities in education, health, public works, and irrigation should be decided and provided at the local level. On the other hand, we share the staff's and the authorities' caution on the potential complications on fiscal management. A significant proportion of the fiscal problems in the larger Latin American economies have stemmed at the subnational levels. Clear revenue sharing rules, as well as the fiscal autonomy and fiscal responsibility rules, should be made very explicit. Can the staff expand on the subject? Have the authorities established technical assistance through the Fund or outside to help in the fiscal components of the Devolution Initiative?

On the external sector, we share the authorities' concern expressed in Mr. Mirakhor and Mr. Ahmed's preliminary statement that external reserves, while improving, are still at a low level, which calls for vigilance and prompt action, should the situation warrant.

In regard to the monetary and exchange developments, we share the staff's view that the coordination of monetary and exchange rate policies will be critical for the success of the stabilization program. To the extent that the authorities effectively move to a genuinely flexible exchange rate regime, new options would open for a more adequate monetary management. Given the instability in money demand as reflected in the volatility of demand for cash balances, monetary management could move towards the adoption of an inflation-targeting framework. Net domestic asset (NDA) targets could be substituted with consultations with the Fund if inflation deviates significantly from targets and no new unorthodox measures to comply with performance criteria would be required. Is inflation targeting an option according to the staff?

In regard to structural reforms, we welcome the authorities' efforts in improving governance, especially in areas such as the better management of public resources and the development of a transparent regulatory framework conducive to efficient private sector activities. The strengthening of governance will be particularly significant also in the devolution of power to local authorities through fiscal decentralization. As Appendix III indicates, improving governance will have an important positive impact in fighting poverty to the extent that rising poverty in Pakistan has been associated not only with the outcome of adverse exogenous shocks, but as a result of bad governance in past years.

While we agree that there remain "significant risks" to achieving the program's objectives, we are encouraged by the authorities' confidence expressed by Mr. Mirakhor and Mr. Ahmed that they are up to the challenges confronting them and that the known risks are manageable. We fully support the proposed decision and wish the authorities well in their endeavors.

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

At the initiation of the current program we had some apprehensions regarding its success. Given that, we were quite pleased to read that the program was broadly on track and even exceeded some expectations. The support of the Fund and other IFIs has given Pakistan an opportunity to gain back the positive sentiment of the international capital markets. We think that in the past few months the authorities have done well in showing their determination to move ahead with structural reforms while preserving macroeconomic stability. Yet, this is only the beginning and there are significant external and internal risks present. We thank the staff for a good paper. We support the completion of the review, the request for a waiver and the modification of the performance criteria. Let us offer a few comments on the implementation of the program and on the steps forward.

While commending the authorities for keeping the program on track, we do note that some of the measures that have been taken to achieve the program's targets were unconventional with regard to monetary policy, and contingency based with regard to fiscal policy in nature.

We welcome the increased flexibility of the exchange rate and the narrowing of the premium between the kerb and the official rupee exchange rates. Further rupee depreciation, while aligning it with the market-determined level, could also help out with the country's export performance. We have several concerns, however, about the State Bank of Pakistan's (SBP) interventions in the foreign exchange market. First, the SBP continues its intervention in the forex market beyond the operations to smooth out temporary effects of bulky transactions, i.e., through purchasing foreign exchange in the kerb market and selling it in the interbank market. This issue has been "on the table" for quite a while, and it is worrisome that such practice continues to remain at a high cost to the SBP. Second, the continuing use of swaps is questionable. The staff states that several commercial banks engaged in foreign exchange swaps with the SBP to increase their rupee liquidity, which means that they bought rupees from the SBP at some predetermined exchange rate. While we have our speculations on why the SBP engages in such transactions, we would appreciate it if the staff could comment on this issue, and especially why commercial banks do not increase their rupee liquidity through selling foreign exchange directly to the interbank market. Promises have been made in the past that the swap transactions would be curtailed and that forex purchases would be redirected to the interbank market from the kerb market. Frankly, we do not see much improvement, except maybe for a "time out" in recent swap dealing according to the staff's latest update. With one of the main objectives of the program being the buildup of international reserves, we really do not see much room for such activities.

Credit growth has intensified in the recent months and, along with the increased demand for cash, threatened the achievement of the monetary policy targets. The staff state that credit growth primarily reflected higher financing needs for the textile sector and buoyant leasing activity. Given that the GDP growth was lower than projected, are the staff concerned about this rapid credit growth in such an environment? While the demand for currency is not projected to revert to its trend levels, are there indications that demand for credit will also continue to grow at the current level? How is the banking system handling this excess credit? Have provisioning levels increased accordingly? After all, according to Annex IV of EBS/00/230, the banking sector is overexposed to the textile sector and a large share of nonperforming loans are attributed to it.

The end-December NDA target was met through a number of unorthodox steps, which, in our view, are also nontransparent and confusing. We support the staff in their view that by not tightening the monetary policy through conventional ways, such as interest rate increases, the authorities were jeopardizing the sustainability of the monetary environment needed under the program. After all, at the initiation of the program the authorities "stood ready to raise interest rates" if monetary targets were not being met. An interest rate increase may also have been helpful in limiting the excessive credit growth. We hope that this unorthodox practice is not going to repeat itself and, thus, we welcome the proposed modification of relevant targets. Accordingly, we support the staff's advice laid out in paragraph 19 regarding the conduct of the monetary policy in the future. We welcome the recent tightening of the monetary policy.

We would say that we were not surprised that tax revenue targets were not achieved. After all, all the indications were there at the initiation of the program, starting from the weak revenue collection data in the first quarter and ending with having explicit contingency measures. While being content that these contingency measures have been present under the program and obviously executed in order to reach the fiscal target, we are concerned that cuts were made in the Public Sector Development Program. While some of the cuts may have been warranted to improve selectivity and efficiency of the projects, others seem to be limiting the development opportunities which are so needed in this poverty-stricken country. Here, we have in mind reductions made in the Ministry of Health, Population, and Housing and some other areas. This and the fact that poverty-reducing expenditure fell short of program objectives at provincial levels are unfortunate consequences of the need for fiscal tightening. Having said this, we wonder whether there are contingency measures envisaged to achieve the next review's target and whether the staff see this end-year development expenditure target being achieved. Or is there no need for contingency measures given the modification of criteria and remedial measures that have already taken place?

Briefly touching upon the revenue performance, we are somewhat concerned that tax revenues fell short of the target because the diversion of staff resources from regular tax activities to the tax survey, which reduced audit capacity and adversely affected collection enforcement. This is worrisome since at the initiation of the program it was said that a number of steps had been taken to minimize this type of risk. Shortages in tax revenue collection have also resulted from the persistent weaknesses in tax administration. Therefore, we are glad to see that the authorities are on track with their plans for a fundamental overhaul of the tax system and that steps were taken in reassigning 400 auditors to implement sales tax audits.

It is good news that the external current account is projected to remain as programmed, although some serious vulnerabilities exist. Export performance, though, is something to be watched carefully, given the drop in unit values and a potential slowing down of the world demand and especially the developments in the economies of the main trading partners. The external debt strategy seems to be intact as well. In this regard, we wonder if the staff had a chance to get familiar with the recent report produced by the special committee appointed by the government to suggest the ways to manage and reduce the pressing debt burden. One of the suggestions made in the report was to seek exceptional assistance from the IFIs in the amount of US$6 billion and rescheduling from the Paris Club in the amount of US$4 billion to meet the financing gap up to 2004. Since the numbers in the program laid out in Table 7 are somewhat different for these categories, we wonder if the staff could comment on the differences and just generally about this report and suggestions made in it. In any case, we welcome the continuous close attention paid by the authorities to the issue of the debt resolution.

We are pleased to see the continuation of the reform effort in this area. We support the authorities' request for the FSAP. We believe it would be useful for Pakistan and think that it should take place after the transition to the new system of banking principles. In regards to the latter, while we are glad to see a somewhat more extensive coverage of this topic in the report, many of the questions remain unanswered. Also, it seems like this process needs to take time since some important issues remain unresolved, for example, the design of specific financial instruments to manage monetary policy and the interbank market. We are still perplexed about how monetary policy tools, for example, interest rates—a primary tool at present—could be used under such a system. In addition, little has been done on how to implement the transformation of bank activities to a new system. In this regard, could the recent surge in lending be attributed to the desire to make more profit before a lengthy transformation process takes place under the new system? We wonder if there is a possibility of moving the deadline for July implementation. As to other reforms in the banking sector, we welcome the authorities' efforts in strengthening the system's soundness and in promotion of competitiveness. Concerning the nationalized commercial banks, we support the strategy of envisaged privatizations, but are concerned about the substantial recapitalization cost that will involve public funds.

Finally, we welcome the authorities' efforts to improve governance and statistics, the areas where a lot of work still needs to be done.

Mr. Collins and Mr. Taylor submitted the following statement:

When we discussed this SBA last November, this chair, with others, drew attention to several key concerns. These included fiscal policy, which had been characterized as the Achilles' heel of the economy, Pakistan's vulnerability to terms of trade shocks, and worries that investor confidence and private capital inflows would not recover sufficiently to meet Pakistan's substantial external financing needs.

Four months on, these concerns remain, and looking ahead to the second half of the fiscal year we agree with the staff's assessment that there are some substantial downside risks both for the economy and also for this program. Even the revised forecast for economic growth in 2000/01 of 3.8 percent may be optimistic because of the impact of the drought, slowing external demand, and the impact of higher fuel prices. Given that the relatively weak international prices for Pakistan's major export crops may not recover in the near term, what contingency plans are in place if growth comes in lower than predicted or if reserves are significantly depleted?

It was recognized at the outset that this year's target increase for tax revenues of 1.1 percent would be a stretch, and so thus far it has turned out. While we appreciate the real efforts which the authorities have been making through the tax registration drive and other measures to expand the tax base, it appears to us that the problems in the administrative system are deep-seated and may not be amenable to the sort of short-term action plan which is now being proposed. More particularly, we were disturbed to read on page 17 of the report of resistance from the Central Board of Revenue to the reform effort. We share staff's view on the need for steadfast action by the government to enhance revenue capacity.

The forthcoming extensions of the GST and income tax are clearly of great significance to the success of the program, and in this regard we would welcome an update on the plans to extend GST to pesticides and urea fertilizers by the end of this month.

On expenditure, we note that social and poverty-related spending fell short of targets in the first six months of the fiscal year due mainly to deliberate restraint and better enforcement of accountability and governance standards at the provincial level. We appreciate the undertaking given to meet the end-year target for social sector and poverty-related expenditure, but we wonder in what ways the accountability shortcomings already identified are being addressed. Is there any sense that management and delivery systems at the district level may be deteriorating?

The Pakistan authorities have indicated that they will seek to move from this SBA to a PRGF. Key to such a shift will be delivery of planned increases in social spending for the poorest as targeted in the interim PRSP. The recent Development Forum discussed the IPRSP and acknowledged the effort and serious commitment which the authorities are making, but also underlined the need for a credible implementation plan to tackle governance issues and deliver social services in a devolved context. Staff have pointed to the risks which devolution could present if there is not rapid progress in preparatory work, including enhancing the administrative capacity at the district level. Given that district administrations are due to take up their new functions in August, a daunting agenda lies ahead.

While the authorities were able to meet the performance criteria at year-end on Central Bank net domestic assets, there is a candid admission in the MEFP that the underlying monetary stance was more expansionary than indicated by the artificially depressed reserve money stock. The staff appraisal refers to the unorthodox measures which the State Bank of Pakistan took by allowing banks to convert temporarily the rupee counterpart of foreign currency deposits of nonresident institutional investors held by SBP into T-bills. This is tantamount to meeting the letter of the performance criterion without meeting the substance. Are there backup criteria which could be introduced to prevent this from happening again? In this connection, we are very concerned by recent press reports that the State Bank may again be resorting to these unconventional measures to meet the March performance criteria. Such measures could undermine the monetary policy stance and associated targets envisaged in the program.

Developing the right investment climate is essential in order to boost medium-term growth, so we welcome the resolution of the outstanding IPP issues with the undoubtedly positive impact this will have had on international investor sentiment. It would be unrealistic to expect this to be immediately reflected in FDI numbers, but, nonetheless, foreign direct and portfolio investment inflows were lower than predicted and we would like to hear more from staff on the possible underlying causes for this. We also note that the financing gap of $2 billion for 2001/02 will require additional debt rescheduling from official and private creditors.

We read with interest the summary of conclusions of the on-site assessment of the SBP. It is pleasing to see that the SBP has collaborated productively with this investigation. It will be essential to ensure that the longer-term remedies for strengthening the Central Bank's risk management and control systems in line with international best practices are pursued with vigor.

While we have highlighted our concerns, we also recognize the genuine efforts which are being made against a difficult external backdrop. Much remains to be done, but we are pleased to support the completion of this review, granting of the waivers and modification of the end-March performance criteria.

Mr. Usman submitted the following statement:

We thank the staff for a well-balanced document highlighting Pakistan's performance under the First Review of the Stand-By Arrangement (SBA), and Mr. Mirakhor and Mr. Ahmed for an informative and candid preliminary statement. We are pleased that Pakistan met most of the performance and quantitative criteria under the SBA, some well ahead of time.

Pakistan performed well during the period under review. Inflation was well contained, budgetary performance was better than expected, and the external current account improved markedly. Economic growth during the period under review, however, was lower than projected, influenced to some extent by adverse weather conditions, which had a negative impact on agricultural output. Industrial output has since, nonetheless, started to rise.

While income fell short of program targets, the authorities adjusted expenditures to enable them to meet their overall fiscal targets, albeit at the expense of reduced poverty-related outlay and lower current and capital expenditure at provincial levels. We commend the authorities' subsequent efforts in addressing revenue shortfalls. In this regard, steady progress has been made in preparing for income tax reforms, and the Central Board of Revenue (CBR) has implemented measures to improve tax administration. Further implementation of the intended fiscal reforms, aimed at strengthening the administrative capacity, should improve Pakistan's income-generating capacity to provide the authorities sufficient room to address poverty-related issues.

We note the staff's concern on the expansionary monetary policy stance in the face of Pakistan's fragile balance of payments position and the low level of reserves. The authorities have, however, since tightened the stance by mopping up excess liquidity and raising the interest rate. This had a positive effect on their reserves position, which was under pressure during the first two months of the year.

Important progress was also made on the structural side, as noted by Mr. Mirakhor and Mr. Ahmed in their preliminary statement. We welcome the efforts to improve governance by implementing measures to improve management of public resources and to support the development of transparent economic and regulatory environment including the enhancement of fiscal and financial transparency at all levels of government. Continued restructuring of the financial sector resulting in the closure of unprofitable branches of major nationalized commercial banks is also commendable. Substantial recapitalization of nationalized banks will be needed, as the staff have suggested, before their privatization can be considered. The authorities' intention to sustain financial sector restructuring is illustrated by their request for a Financial Sector Assessment Program.

We note that important progress has been made in addressing data-related issues, although such efforts need to be accelerated at provincial levels to facilitate the ability to monitor developments under the program. We would therefore urge the authorities to press ahead in that regard.

We are encouraged by the reassurance of Mr. Mirakhor and Mr. Ahmed that Pakistan is up to the challenges in confronting and managing known risks to ensure the success of the program. We support the proposed decision and wish the authorities every success in their future endeavors.

Mr. Al-Turki made the following statement:

Performance of the Pakistani economy under the program has been broadly favorable. The better than expected inflation picture is particularly welcome. However, draught conditions and shortfalls in external financing have weakened growth. Therefore, I support the request for a waiver and modification of performance criteria.

The challenge now is to build on the progress made and address the structural causes of the economic imbalances. The authorities' commitment to the program, as noted in Messrs. Mirakhor and Ahmed's statement, is reassuring. Here, I will add a few remarks.

The overperformance in the fiscal area is encouraging. In this connection, I welcome the efforts to restrain expenditures and enhance efficiency through better enforcement of accountability. The increases in tariffs of WAPDA are also a step in the right direction. These efforts need to be advanced in order to free the needed resources for priority infrastructural projects.

This overperformance notwithstanding, the shortfall in tax revenues underscore the need for greater efforts. Thus, the importance of broadening the tax base and strengthening tax administration cannot be overemphasized. In this connection, the tax survey is an important step in the right direction. I am also reassured by the ongoing implementation of the short-term action plan agreed with the Fiscal Affairs Department.

Another important element of the program is the buildup of official reserves. In this regard, the substantial increase in reserves over the past month is most welcome. The tightening of monetary policy combined with adherence to the fiscal targets should further enhance reserve accumulation and facilitate the ongoing movement towards a more flexible exchange rate. That said, it is important to reduce interest rates as soon as it becomes evident that confidence has strengthened. Here, I would be interested in the staff's comments on the impact of the increase in interest rates on growth.

Turning to structural reform, the authorities' determination to sustain public enterprise restructuring bodes well for growth prospects. In this connection, I am encouraged by the progress made in allowing public enterprises greater autonomy in price setting and labor policies while subjecting them to hard budget constraints. It is essential to advance this progress in order to enhance competitiveness and efficiency. I also welcome the ongoing restructuring of the Karachi Electricity Supply Corporation and the resolution of tariff disputes with independent power procedures. The higher tariffs that have recently been implemented should strengthen WAPDA finances and enhance efficiency.

It is reassuring that financial sector reforms are on track. Here, the implementation of a number of measures to facilitate overhauling of the National Savings schemes are noteworthy. I would also emphasize the importance of fully implementing the commitment to accelerate restructuring of the major nationalized commercial banks. A sound financial system is particularly important as Pakistan prepares for the challenging task of transitioning to a system based on Islamic principles. In this connection, I agree with the recommendations of the Fund's Technical Assistance missions "that the transformation should only be done in a careful and orderly manner," and I am encouraged by the remarks of Mr. Mirakhor on this point at the beginning of the discussion. Here, I urge the authorities to continue their close consultations with the staff on this matter, and the Fund to provide the necessary technical assistance in areas where it has the required expertise. I also endorse the authorities' request for participation in a FSAP review at an early date.

Finally, I support the authorities' call for an early negotiations on a program that can be supported by the PRGF.

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

Mr. Wei made the following statement:

I commend the authorities for their commitment to bold and comprehensive reforms in a drive to address the country's economic weakness, especially on structural issues. We have seen the authorities continue to move forward in this direction in the past four months. Recent developments do suggest cautious optimism, with progress being made in many areas while risks remain. I broadly agree with the thrust of the staff appraisal. The staff has done an excellent job in producing a well-written report with balanced assessment, and I am grateful. I would like to thank Mr. Mirakhor and Mr. Ahmed for their helpful preliminary statement. I will limit my comments to three major policy areas.

On exchange rate policy, four months ago the external payments stability was particularly at risk. The reform of the exchange rate system posed a great challenge to the authorities. The situation has since improved somewhat, with the external indicators performing better than expected. The outcome of the current account deficit was better than programmed, while official foreign exchange reserves have risen lately. However, with less than US$1 billion, the amount of foreign exchange reserves is still very low by many standards, given the economic size or external orientation of the country. The balance of payments position thus remains vulnerable. I admire the authorities' determination to continue to press ahead with its trade liberalization and exchange rate reform. Nonetheless, recent experience appears to argue for a more gradual strategy, especially with the latter. Also, careful coordination with monetary policy is of utmost importance at this juncture.

On monetary policy, I find recent developments comforting. It is very hard to judge whether the stance of monetary policy is appropriate within a short period of time, given the complexity of its effect on the economy and its long time-lag. I note that the NDA target under the program was to some extent achieved through unorthodox measures, and it was argued that the stance of monetary policy was actually more expansionary than warranted. Be that as it may, the better-than-programmed performance in terms of the current account and inflation suggested that the problem was unlikely to be serious. Note further that, if the overriding concern was the fragility of the balance of payments position, there were two unexpected offsetting forces at work during the period (namely, the better than programmed fiscal deficit and the successive interest rate cuts by the U.S. Federal Reserve). As the staff noted, following the recent tightening by the Central Bank, the rate on the three-month Treasury is now more than 700 basis points above its U.S. counterpart, as compared with 430 basis points in November. I am wondering whether the Central Bank should consider reducing the interest rate gradually in the coming months given the large difference in the rates between Pakistan and the U.S., as well as the need to stimulate economic growth without compromising its inflation objective. Staff comments will be appreciated.

On fiscal policy, I agree with the staff and many Directors that the overall stance is appropriate. I trust that the authorities will continue to keep fiscal policy on track with the same deficit target for the year. The authorities' action to cut expenditure in response to the revenue shortfall reflected the authorities' seriousness to adhere to the target. However, like Mr. Yoshimura and Ms. Saito, my concern is that cutting development expenditure might be an impediment to long-term growth. Therefore, I would continue to emphasize the importance of strengthening revenue sources and collections, as many Directors and I did four months ago. In this connection, I welcome the commitment of the authorities to move forward with the tax reforms as envisaged under the original program. In addition, it is encouraging to see the Central Board of Revenue continue to implement the short-term action plan to improve tax administration as scheduled. I also commend the authorities for resolving the disputes with independent power producers (IPPs) in a satisfactory manner, and for completing the two remaining prior actions in relation to the energy tariff increases by WAPDA and KESC.

Overall, Pakistan has made considerable progress in reforming the economy under the SBA-supported program against the backdrop of intensification of difficulties both internally and externally. No doubt, the staff is right that significant risks remain in light of the uncertainties surrounding the global economy. Like Mr. Junguito, I feel encouraged by the authorities' confidence, as expressed by Mr. Mirakhor and Mr. Ahmed, that they are up to the challenges confronting them and that the known risks are manageable. Pakistan's economy is at a critical juncture, in view of the progress the authorities have made and the urgency for the country to strengthen its external position, and I fully support the appeal expressed by Mr. Mirakhor in his preliminary statement that we would urge the staff to bring to the Board a proposal for a PRGF-supported program for Pakistan as soon as possible.

With these remarks, I fully support the proposed decision and support the authorities' request for waivers. We wish the authorities complete success in their future endeavors.

Mrs. Mateos y Lago made the following statement:

The Pakistani authorities deserve to be commended for their accomplishments since the approval of the Stand-By Arrangement, not least of which is the achievement of all but one of the many conditions required for the second disbursement. What is more, the authorities were able to provide the donor community with a comprehensive and articulate program for the economy at the recent development forum organized by the World Bank.

Against this background, we gladly support the completion of the first review under the program.

That said, recent developments offer a series of concerns, and although we share the thrust of the staff appraisal, we fear it might be somewhat optimistic regarding both the progress achieved and economic prospects, including the growth rate for 2000/01.

As far as fiscal developments are concerned, we regret that revenue collection fell short of the program target, although it was to be expected, given the limited effectiveness of the taxpayer registration campaign and the lack of fundamental reform of tax administration. Furthermore, while we welcome the containment of the overall deficit below the target, we find it most unfortunate that this was obtained at the expense of social and development spending. Also, given the various downside risks outlined in the staff report and the tendency for spending to accelerate toward the end of the fiscal year, there is a significant risk that the year-end deficit target will be missed. If things were to move in that direction, we would strongly prefer additional revenue measures over so-called low-priority development spending.

With regard to monetary policy, I share the concerns of Messrs. Collins and Taylor with regard to the devices used by the SBP to meet the end-December NDA targets. I would welcome the staff views as to whether this approach is appropriate as opposed to requesting a waiver.

On the external sector, the staff indicate in their statement that there has not been any undue pressure on the rupee. Given that the rupee reached a record low in interbank deals on the day when that statement was issued, I would appreciate if they could elaborate on their conception of undue pressure and how much further they expect the currency to depreciate. I also note that the commitment of the SBP to reduce dollar purchases in the kerb market has not been complied with.

Finally, it is doubtful whether the trade deficit projection can be achieved in light of the performance of the first eight months of the year and of the likely implications of the agriculture crisis for both imports and exports. That said, we strongly hope that the staff projections of medium-term external financing needs can be met. Against this backdrop, how should the remainder of the program be adapted? The proposed revision of the revenue target should only be agreed upon if the authorities understand that it is a lower bound that they should strive to exceed.

Regarding the NDA target, I understand that the proposed modification is the outcome of a compromise between the staff and the authorities, and it can be accepted as such. However, a tight monetary policy will not help much to achieve the foreign exchange reserves target if it is not aimed at tackling the continued lack of confidence among foreign investors. A tight monetary policy will make it even harder to meet the fiscal adjustment objective through cost servicing and its dampening effects on economic activity. The fragility of the banking sector is likely to increase. Net domestic lending registered about 20 percent of assets at end-March 2001, and is rising steadily.

Turning to the structural reform agenda, while we generally agree with the conditions set in various forms in the program, I would like to highlight a few priority concerns. First of all, it is key for the success of the program that the authorities proceed expeditiously with the overhaul of the CBR and of customs administration, beginning with the measures whose positive impact on revenue performance has the shortest lag. Any further delay in that area would critically hamper meeting the social expenditure targets which are key to our support for the program.

Second, while sympathetic with the purposes of the devolution initiative, we agree with the staff that it entails considerable risks not only on the fiscal front but also with respect to governance and the delivery of social services. In addition, carrying out such a complex reform will inevitably put pressure on the limited technical capacity of the administration, which is already overburdened by the rest of the structural reform agenda. Therefore we encourage the authorities to concentrate on improving transparency and accountability within the present institutional structure before undertaking the devolution reform.

Third, notwithstanding Mr. Mirakhor’s opening statement, we are quite worried to note that little progress has been made to prepare the transition of the financial sector to Islamic banking as of July 2001. Given the already weak situation of many financial institutions, especially in the public sector, the authorities should endeavor to avoid a disorderly transition which could be disruptive for the economy as a whole. Also, the present uncertainties surrounding the transition process complicate the task of restructuring and eventually privatizing public commercial banks, which should also be a high-priority endeavor for the authorities.

While we recognize that the authorities have made tremendous efforts and significant progress in all areas covered by the arrangement, this program remains among the riskiest of the Fund’s portfolio, and downside risks to the staff’s baseline scenario have, if anything, increased. Accordingly we encourage the staff to deal with a less favorable outcome should the need arise, and we wish them continued success in their endeavors.

Ms. Lundsager made the following statement:

When this program was approved, we observed that realization of its goals depended critically on strict adherence by the authorities to the commitments undertaken (in spirit as well as in letter), in addition to favorable exogenous developments. This first review provides evidence of some forward progress in key areas, but also shows that program implementation has faltered and that external developments have not been particularly favorable either. These developments raise questions about whether the program's goal of creating the preconditions necessary for the medium-term challenges ahead is still within reach.

Turning first to exogenous developments, we noted in our statement during the last discussion that adverse external developments should be accommodated by increased adjustment on the part of the authorities. Instead, performance targets have been lowered. Continued weaknesses in tax administration have resulted in lower revenue collection, which has been addressed by lowering the CBR targets. The authorities have demonstrated their willingness to take compensating expenditure measures, but have done so at the expense of already low development spending.

While the authorities' revenue-raising efforts have produced some positive results, we remain very concerned about the effectiveness of tax administration. The nonobservance of the end-December revenue target, which followed the nonobservance of the informal end-September revenue target, is troubling since revenue mobilization is a key component of this program. It is also disappointing that there has been little change in the authorities' emphasis on the tax survey and bringing small businesses into the tax net, rather than on increasing the extent and effectiveness of taxation, particularly of large taxpayers. This misplaced emphasis has come at the expense of realizing the program's revenue targets. We hope that determined implementation of the agreed action plan will help reverse these developments. Meanwhile, the proposed revisions to revenue targets will complicate efforts to assess the extent of progress on tax administration going forward.

We note the authorities' demonstrated capacity for expenditure restraint in the face of lower-than-programmed revenues, and would appreciate any further clarification available on the components currently listed as unidentified expenditure. We have some concerns about their decision to restrain low-priority development expenditure. While we recognize that this was identified as a likely target for contingency measures, the decision to underspend in this area (where spending is already quite low in comparison with other countries at a similar level of income), while at the same time meeting defense spending targets, raises questions about the authorities' expenditure prioritization that must factor into any consideration we give to a future request for PRGF resources. Mr. Yoshimura and Ms. Saito raise an important question regarding export diversification. This is key to helping develop the basis for future growth and job creation.

With regard to the authorities' plans for fiscal devolution, we would appreciate more information from both Fund and World Bank staff on whether the current plans can be implemented effectively, or if the weaknesses described in the staff report will disrupt an already difficult fiscal management situation. In addition, devolution is one of the elements of the authorities' plan to improve governance, which is very welcome. However, it will take a determined effort on all the elements presented in Appendix III, and not just devolution, to achieve the desired results.

While recognizing that the authorities faced a genuine need to accommodate higher-than-expected money demand, we share the concerns raised by Messrs. Collins and Taylor. Greater consultation with the staff on an approach to handling higher money demand could have helped the authorities act sooner to reverse the expansion and avoid the subsequent drain on reserves that became apparent in January. Steps taken in the meantime to tighten the monetary stance are welcome, but have come somewhat late in the day, raising questions about the authorities' willingness to use more activist monetary policy to achieve external policy goals.

In our last discussion, we stressed the need for greater exchange rate flexibility to provide a necessary cushion for negative external shocks, or if other aspects of the program's optimistic scenarios do not come to pass. Flexibility could also help promote export diversification. Given the fairly constant kerb market premium, it appears that the exchange rate remains heavily managed. The authorities' next steps move in the right direction but seem quite tentative and cautious, and we noted in the staff statement that the exchange rate spread remains unchanged.

Banking sector reform has moved extremely slowly. Only a few underperforming branches of the most inefficient banks have been closed or reorganized, while the bulk of the banking sector faces serious challenges, and major improvements are still needed in the transparency of financial sector accounting. We hope that an FSAP review can be undertaken in the near future to provide a clear basis for moving ahead with much-needed reforms in this sector. An FSAP review will undoubtedly need to address the likely effects of the planned move to an Islamic banking system. Here, we have real concerns about shortcomings in the authorities' plans for implementing the transformation of conventional banks' activities and urge them to consult with the banks as they develop this plan.

We recognize that the tasks facing the authorities in order to improve data quality are significant, and welcome the progress that has been made to date. However, it is worrisome that progress has slowed in key areas, particularly in accounts reconciliation and reporting at the provincial level. As we indicated above, whatever the merits of the authorities' plans to push ahead with fiscal devolution to local governing bodies, the immediate effects can only be negative if there is inadequate institutional capacity for managing the associated increase in fiscal responsibilities. We remain concerned about the quality of fiscal data and transparency of accounting in the financial sector. In addition, it would be useful to include in future reports an assessment of the outcomes of technical assistance, not just a listing of recent missions.

This is the first time a Board review has included results of stage 1 and stage 2 safeguards assessments since the new safeguards procedures were approved last year. The assessments identified a number of vulnerabilities and generated a range of recommended measures aimed at moving the operations of the SBP toward internationally recognized best practices. It is gratifying to observe that the authorities are responding positively to the recommendations by incorporating them into program goals and conditionality. This was a necessary step for Pakistan in its effort to put last year's misreporting episode firmly behind it. We welcome the authorities' decision to publish all Board documentation related to this review.

U.S. domestic law, and specifically the Glenn Amendment through its reference to the International Financial Institutions Act, states that the U.S. Executive Director is to oppose (meaning, inter alia, to abstain from voting or vote against) non-Basic Human Needs IFI assistance to non-nuclear weapons states that detonate a nuclear explosive device. On May 30, 1998, the President of the United States determined that Pakistan detonated a nuclear device, triggering this Glenn Amendment provision. The U.S. government has stated that it would consider waiving Glenn sanctions against Pakistan should it sign the Comprehensive Test Ban Treaty. The government of Pakistan has not taken such action.

In light of these provisions under U.S. domestic law, the United States will abstain on the decision to complete the first review.

Mr. Kelkar made the following statement:

At the outset, I wish to thank the staff for a lucid and comprehensive report for today's discussion. The helpful preliminary statement of Mr. Mirakhor and Mr. Ahmed has also provided useful insights about the positive developments taking place in the Pakistani economy. Since I am in broad agreement with the thrust of the staff appraisal, I can be brief.

The overall performance under the Stand-By Arrangement has been encouraging so far, though the macroeconomic conditions in Pakistan remain difficult. Notwithstanding good achievements on the inflation and external current account front, severe drought conditions in the country have adversely affected prospects for the agricultural output, necessitating lowering of growth projections for the current year. The external environment has also become more difficult with a likely slowdown in external demand that could have adverse implications for exports. The country has also remained vulnerable to external shocks due to a weak external position as evidenced by frequent pressures on the official reserves. Therefore, it is imperative that the authorities should vigorously monitor the implementation of the program to improve the macroeconomic situation and address deep-rooted structural weaknesses persisting in the Pakistani economy.

Fiscal adjustment has been identified as one of the key requirements for the success of the program to address serious and long-standing problems as current expenditures have consistently exceeded total revenues in the recent past. Though I welcome better than programmed fiscal adjustment in the first six months of the current year, it could be achieved only through reducing expenditure to compensate for lower tax revenue. At the time of approval of the SBA, I had said that the program envisaged a reduction in the fiscal deficit by 1.3 percentage points of GDP, which was predicated on a growth rate of around 20 percent in tax revenue collection that could turn out to be ambitious considering the weak performance in the first four months of the fiscal year. Therefore, I am not surprised to note that the target of the CBR was missed and the corresponding quantitative performance criterion for end-December 2000 could not be achieved.

The underperformance in revenue collection has required lowering of the earmarked expenditure on developmental activities for the current year from an already low level of 3 percent of GDP to 2.8 percent under the revised projection. The continuous decline in development expenditure in the last five years remains an area of concern considering that social needs and infrastructure expenditure demands in the country remain sizable. I also continue to remain unsure about the envisaged reduction in interest expense by 0.8 percent of GDP under the revised projection for 2000–01, which seems difficult to achieve in view of the proposed tightening of the monetary policy stance in support of the foreign exchange reserve targets and sharp depreciation in the currency in the current year. It might be desirable to consider a realistic figure in this regard. I join the staff in welcoming the authorities' resolve to move forward with tax reforms as envisaged under the original program. The proposed plans for extending the GST to agricultural inputs and the retail sector, overhauling the income tax, strengthening the revenue base, and reforming the tax administration will serve the country well in restoring macroeconomic stability and improving public debt dynamics.

I am concerned to note from the paper that renewed pressures were felt on the official foreign exchange reserves despite continued purchases in the kerb market by the State Bank of Pakistan (SBP). I reiterate my earlier position that the functioning of the kerb market has proved to be a major source of vulnerability for the smooth functioning of the foreign exchange market. The authorities should desist from transacting in this market and take measures to check its growth. Unless urgent steps are taken for enhancing the depth of the interbank market, it is doubtful whether Pakistan would be able to improve its vulnerable external position. The previous staff report had documented the ill effects of the functioning of the kerb market on the Pakistani economy, in particular the large number of unlicensed money changers involved. In such a situation, the decision of the State Bank of Pakistan to continue making large purchases from this market also raises some questions about the propriety of such transactions. I share the concern expressed by Mr. Lushin and Ms. Vtyurina that such practice continues at a high cost to the SBP. In the last Board meeting, the authorities were urged to reduce SBP's purchases from this market and ensure that all legitimate current transactions take place in the interbank market. I would request the staff to indicate whether the quantum of purchases has come down in the third quarter and whether the authorities are planning to discontinue this practice in the near future. We suggest that a definite time frame for phasing out these purchases be decided and a system of rigorous monitoring by the Fund be instituted.

As noted by Mr. Mirakhor and Mr. Ahmed, an unanticipated surge in the demand for currency has complicated the task of monetary policy. The staff paper has mentioned possible reasons for the above-trend demand. We would request the staff to carefully analyze the factors contributing to the unanticipated expansion of currency holdings and report at the time of the next review.

I welcome the resolution of long-standing disputes with independent power producers and commend the authorities for the steps planned for strengthening the energy sector. I also welcome the request of the authorities to participate in the Financial Sector Assessment Program.

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

Mr. Mirakhor stated that the Central Bank did not engage in purchases of foreign exchange from money changers, and that it dealt only with reputable, recognized, and licensed foreign exchange dealers.

Mr. Kelkar requested comments from the staff on the procedures of the State Bank of Pakistan and the amount of foreign exchange transactions undertaken.

Mr. Donecker made the following statement:

Pakistan's severe economic problems appear to have eased somewhat in the first half of the current fiscal year. The overall budget deficit declined, and the current account deficit and inflation were kept in check. On the structural and governance front, there are encouraging signs that the backlog in some areas is finally being addressed. Any measures short of this would have been disappointing. I would stress the staff's assessment that the program's risks remain high. In some respects, risks may even have increased, as evidenced by the downward correction of growth projections or the slower-than-expected rise in foreign exchange reserves. Against this background, the renewed deviations from the program, in particular those in the key area of government revenues, are regretful if not altogether surprising. It should be re-emphasized that the fragile macroeconomic situation and the large and ongoing needs for external financing leave virtually no room for slippages.

To illustrate my concerns, I shall make five brief comments on fiscal policy, monetary and exchange rate policy, financing requirements, fiscal data, and the financial sector.

First, it is of utmost importance that the revised revenue targets be met, given the limited room for further compression of government spending. The short-term action plan for improving tax administration, the fundamental reform of the Central Board of Revenue (CBR), and the planned reforms of the general sales tax and the income tax should all be pursued vigorously. On the expenditure side, the recent shortfall of poverty-related outlays is especially regrettable in view of the unchanged high level of defense spending which amounts to nearly one quarter of total current expenditure.

Second, the authorities still seem to be hesitant to move towards a more flexible exchange rate, as suggested by the ongoing foreign exchange interventions. A withdrawal from the kerb market and a discontinuation of foreign exchange sales in the interbank market would help to reduce Pakistan's external vulnerability. We urge the authorities to move in this direction. On monetary policy, like Mr. Collins and Mr. Taylor, we are worried by the unorthodox measures whose sole purpose seems to have been to meet the letter of the related performance criterion without meeting the substance. In our view, such operations are not very amenable to our shared goal of enhancing the ownership and effectiveness of Fund conditionality. I also wonder whether the increased demand for cash in the system is not one of the early effects of the intended change to Islamic banking.

Third, we note that the already low reserves target will have to be reduced even further in 2000–01 because of expected shortfalls of external financing. More generally, it is troubling that the financing gaps will likely remain large in the medium term even with satisfactory implementation of the

Fund-supported program. The authorities must continue their efforts to reach debt reschedulings from the Paris Club and from other official bilateral creditors on comparable terms, and to secure adequate private financing, including rollovers. A substantial private sector involvement is crucial for the success of Pakistan's stabilization strategy. Strong efforts will also be important to implement in a timely fashion the structural measures agreed with the international financial institutions involved. In this connection, we regret the delays in the processing of the agricultural program loan by the Asian Development Bank.

Fourth, we join the staff in encouraging the authorities to accelerate efforts to address data problems at the provincial level. This issue is not only of great importance in view of the reporting problems in recent years. It is also crucial in order to contain the budget risks associated with the authorities' devolution plan. This program is apt to greatly challenge administrative capacities, and strong efforts will be needed to make it work.

My last point refers to the planned introduction of Islamic banking methods by the middle of this year. Given that this move constitutes a major change for Pakistan's financial system, it is not very comforting to learn from the staff that the preparations are proceeding slowly in some important areas. I would appreciate if the staff could comment on what measures are planned and on what impact they may have on financial stability in Pakistan. For example: Will it constrain the government's ability to raise money on the domestic debt market? Will existing domestic loans and deposits also be subjected to the new rules, which might cause legal disputes? And will there be any room for financial institutions to choose between Islamic and conventional banking methods?

During our last discussion on Pakistan, one Director described the present Stand-By Arrangement as Pakistan's "last, last chance." All in all, and considering the prior actions implemented to date, I do have the impression that the authorities are genuinely willing to seize this chance. It is on this basis that I can go along with the proposed decisions, notwithstanding the significant program risks and the ongoing difficulties of policy implementation in certain important areas.

Mr. Le Fort made the following statement:

We would like to commend the Pakistani authorities' efforts to keep their program on track despite adverse economic conditions. Real GDP is growing, although at a somewhat lower rate than expected. Inflation has been further reduced, the external position improved, and most importantly, the fiscal target was achieved. The balance, however, is still mixed. Some important weaknesses in key areas remain, as policy slippages have affected macroeconomic performance and delayed structural reforms. In particular, the shortfalls in public sector revenue, social spending, and insufficiencies in monetary policy are reasons for concern. As recognized by Mr. Mirakhor and Mr. Ahmed in their useful preliminary statement, today's review constitutes a small step toward long-term adjustment and reform.

Despite improvements, the fiscal position remains vulnerable. Unfavorable external shocks and an insufficiently tight monetary policy have fostered speculative pressures on the rupee. Inflation remains subdued, but the adjustment in administrative prices and further depreciation will increase inflationary risks. In this regard, we welcome the increase of international reserves and the easing of depreciation pressures on the currency resulting from a tighter monetary policy stance.

The staff indicate that the NDA target was met through unorthodox measures as described in the memorandum on economic policies. The higher-than-expected demand for currency was a significant shock that put the quantitative monetary targets off track. The proposed modification in the NDA targets is a recognition that the original targets have lost relevance and that high demand for currency in 2000 will continue in 2001. Experience has once again shown that demand for money is extremely difficult to predict, resulting in volatile and unpredictable monetary conditions associated with the quantitative targets. However, a successful floating exchange rate regime requires a monetary policy that provides a nominal anchor for the economy; ignoring the target is not a solution.

Under existing conditions, given the low level of international reserves, monetary policy should stick to quantitative targets and respond to higher than expected money demand, especially by the accumulation of additional net international reserves so as to effectively provide an anchor. The Central Bank should be ready to buy foreign exchange in the currency market beyond a certain threshold without sterilizing, thus allowing for an increase in money supply, and for the interest rate to respond to market conditions. On the other hand, if money demand falters, NDA should be contracted and monetary policy tightened. To the extent that capital inflows are not excessively large and volatile, it would be possible to sustain this type of policy, largely dependent on judgment, for some time. However, a more structured approach will be needed as a definite solution.

Institution building appears to be a prerequisite for a more effective monetary policy under a flexible exchange rate regime to the extent that the demand for money is volatile and quantitative targets are not effective. By eliminating the monetary financing of the public sector and by giving independence to the monetary authority, accountability in meeting the permanent objectives of monetary policy will be enhanced and the nominal anchor strengthened. Under this system, adjustment in the interventions in the money market could be performed by the Central Bank with a view to keeping the nominal anchor at work.

The decision by the State Bank of Pakistan to approve further cuts in subsidies under the export financing scheme and the withdrawal of the restrictions on commercial banks' placement of foreign currency deposits abroad is welcome. We also welcome the authorities' decision to undertake an FSAP review. We agree that the adjustments in the fiscal stance, considering the program, are appropriate. However, the vulnerability of the fiscal revenues and the narrowness of the tax base are issues that need to be addressed. The expenditure restraint during the first semester of 2000 allowed the authorities to comply with the fiscal target, but it is evident that the medium-term viability of the fiscal account will require strong improvements in tax administration. We are also concerned that part of the expenditure restraint came from lower-than-expected social and poverty-related expenditure, but after Mr. Mirakhor's explanations, we welcome the authorities' efforts to improve the transparency and accountability in the use of public funds. Improving the quality and the amount of social spending should be an important priority. The implementation of the short-term action plan for the Central Board of Revenue, according to the regional schedule, is a welcome development. Also, the increase in the average electricity tariff rate as well as the introduction of automatic price adjustments are an essential element of the reforms.

We have some concerns regarding the lower growth and shortfalls in external financing for 2000 and 2001 and the prospect for covering the large external financial gaps for the next three years. Even with tighter fiscal and monetary policy and further flexibility of the exchange rate, external financing conditions may remain difficult.

Finally, we concur with the staff that, despite a significant risk faced by the program, the balance is favorable. Significant advances are being made, and the authorities have demonstrated a commitment to the reform program that deserves support. All prior action of this review and most of the quantitative and structural performance criteria during December have been met. Consequently, we support the proposed decision and the request for a waiver and modification of performance criteria. We encourage the authorities to persevere in implementing their comprehensive macroeconomic program. Moreover, we believe that after the successful completion, the authorities should consider a medium-term program that could be supported by the PRGF.

The staff representative from the Middle Eastern Department (Ms. Eken), in response to questions and comments from Directors, made the following additional comments:

> There are a broad range of questions covering growth, monetary and exchange rate policies, fiscal policy, and structural reforms. I will start with questions related to growth. One question addressed the impact of the recent increase in interest rates on growth, while another related question addressed the increase in interest rates on the budget. Pakistan's financial markets are relatively segmented, and the transmission mechanisms of monetary policy actions has not worked well. The elasticity of banks' lending rates with regard to changes in Treasury bill rates was zero over the year 2000. Recent increases in Treasury bill rates are unlikely to have a strong impact on bank lending rates in the year 2001. Moreover, interest sensitive demand components are affected by other factors. Capital goods are imported and not produced locally.
>
> Regarding the impact of the higher interest rate on the budget, the recent increases in interest rates have been on the six-month Treasury bill rate, and thus the impact of the increase will take effect on next year's as opposed to this year's budget. However, the size of the domestic debt in Pakistan is 43 percent of GDP. If interest rates were to go up one percentage point more than what is assumed under the program, the full-year effect on the budget would be about 0.4 percent of GDP, which is quite significant.
>
> Growth could also be affected by developments in agriculture as well as to some extent the external environment. The staff may have underestimated the impact of the drought on growth, but at this stage it cannot be determined because the cotton harvest registered levels close to those of last year. For the wheat harvest coming in May, the staff and the authorities have assumed a 10 percent decline from last year's level. For the past two years there were drought conditions, but nonetheless record harvests. What matters is the water level in the dams that feed the irrigation systems, which is becoming low at this moment and constitutes the reason for concern. If the drought continues and the water level in the dams is depleted, then the forthcoming cotton harvest will be in danger. If this were to happen, it should not greatly affect this year's growth performance but would have major implications for next year's growth performance. If the wheat crop is affected by the drought or drought-related problems, there are stocks available for consumption for a few months, but there might be need for large imports next year. The situation has to be assessed during the next staff mission in May.
>
> A slowdown in world economic growth is built into the program. However, if there is a deep recession, then it will definitely affect the performance of the Pakistani economy. From past experience, a slowdown in demand in industrial countries translates into lower export unit values. Depending on the severity of the situation, it could also affect the volume of

exports. One percent real growth decline in the world economy would increase the current account deficit in Pakistan by 0.2 percent of GDP and would reduce reserves by one week's holdings. If the external environment does deteriorate more than expected, it is important that the exchange rate remains competitive. The scheduled mission to Pakistan in May will reassess the situation, and if the circumstances are as severe as they potentially could be, then the whole framework has to be reassessed.

On capital flight, private capital flows coming into Pakistan are typically not allowed to leave. Therefore, the risks of capital flight are less than in other emerging markets, including Turkey.

On the exchange rate market, and in particular transactions in the kerb market, there are a few reasons why spreads in the kerb market have not come down from around 5 percent. The kerb market premium is a reflection of the existing restrictions on capital account transactions. As long as these restrictions exist, the premium cannot be expected to disappear. While the balance of payments situation has improved, it remains fragile, so investors in Pakistan may ask for a valuation gain to compensate for the perceived country currency risk above and beyond the interest rate differential. There are also pressures in the kerb market coming from SBP purchases. Compared with last year, the amounts of these purchases have come down, as promised by the authorities. So far the amounts of purchases in the kerb market by the SBP is a little over US$1.5 billion, which is less than last year, although if it continues at this pace, the total amount targeted for year 2001 might be exceeded. The authorities have indicated that they will move their purchases gradually from the kerb market to the interbank market. In conjunction, the authorities are improving the functioning of the interbank market so that it becomes more attractive to transactions.

The use of base money as a nominal anchor was recommended by a MAE technical assistance mission two years ago, and thus experience with its performance is relatively short. In Pakistan, other possible anchors would also be subject to uncertainties. Inflation targeting would be a viable option in the future, but at this stage it would not be the most appropriate option; the CPI and PPI data available are not reliable, and the track record in terms of short-term and medium-term inflation forecasting is not good.

A number of Directors commented on the unorthodox measures that were used by the authorities to meet the net domestic asset target. The authorities wanted to meet the performance criteria, and were explicit about the unorthodox measures taken to do so. There was nothing hidden in this exercise, and they have committed not to use these measures again. As has been seen in the last month or so, open market operations are being used as a means to affect monetary conditions. The staff has built into the program an adjuster to prevent the use of changes in the base for cash reserve requirements as a means to meet performance criteria on the NDA of the State Bank of Pakistan. Foreign exchange swaps are an instrument for short-term liquidity management by monetary authorities, and are used in Pakistan as well as many other countries. Banks were short of liquidity because of a high demand for private credit. As would be expected, banks reduced their Treasury bill holdings and resorted to the SBP's discount window to obtain liquid funds. Against these developments, the targeted 1.1 percent decrease in reserve money under the program would have required a drastic tightening of the monetary policy stance. One of the ways the SBP managed to meet the increased demand while still meeting the reserve target was to engage in foreign exchange swaps. Swaps are excluded from the foreign exchange reserve target and also from net foreign assets. Therefore, they were not done to meet the objective of the reserve target; they were done for liquidity management purposes.

Ms. Vtyurina asked why the staff had said in past papers that short-term swaps should be discontinued, if that was a regular procedure that Central Banks could use.

The staff representative from the Middle Eastern Department (Ms. Eken) answered that the staff had not excluded the use of short-term swaps for short-term liquidity management purposes, but did exclude the use of short-term swaps to meet foreign exchange reserve targets.

Mr. Zurbrügg asked if the staff was consulted at any time by the authorities regarding the trade-off of engaging in short-term swaps and other unconventional measures.

The staff representative from the Middle Eastern Department (Ms. Eken) responded that, at the time of the formulation of the program, the staff had been concerned that the program's performance criteria on the NDA of the SBP were too ambitious. The authorities had been told that they might have difficulties meeting them. Until the month before the deadline, there had been indications that it would be difficult to meet the end-December performance criterion on the NDA of the SBP. Nonetheless, the authorities said they that they were committed and would meet it and that the staff should not worry. The staff did not know how the authorities would meet it, but recommended the use of open market operations and an increase of interest rates.

Mr. Junguito noted that base money was to be used as the nominal anchor in the future as long as inflation targeting was not feasible, and wondered whether there should not be explicit rules that adapted the NDA target to changes in money velocity rather than using unorthodox measures.

The staff representative from the Middle Eastern Department (Ms. Eken) observed that for the financial program the staff had established quarterly reviews to monitor developments. If they differed from the projections, the staff would return to the Board and explain what should be changed and why. The targets could be changed only after Board consideration.

Mr. Donecker asked whether it would not have been more appropriate to request a waiver instead of using unorthodox measures to meet the targets. Other countries had done so, and it was a good reason for a waiver, although discretion remained with the Board.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael) remarked that, from the point of view of the final impact, Mr. Donecker was right that if the authorities had simply broken a performance criterion, and had explained that the reason why was a justifiable increase in demand for money, a waiver could have been considered. However, the authorities might have been so concerned to meet the targets and show a good performance that they did not want to request a waiver in this regard. The use of the unorthodox measures was not appropriate. In the modified targets and the adjusters for the performance criteria, adjustments had been introduced with a view to keeping the authorities from taking recourse to such unorthodox measures again. The staff preferred monetary targets that were realistic, and in that spirit, the March targets had been adjusted while monetary policy had been tightened at the same time. It seemed that the demand for money in Pakistan was subject to some short-term instability, and it was difficult to predict the money demand even three months ahead. Those were normal problems, and the program remained on track in terms of the monetary targets. The staff appreciated that the authorities had been open and transparent about the use of the unorthodox monetary policy measures. If the demand for money stabilized, it was likely that similar events would not recur.

Mr. Mirakhor responding to Mr. Donecker's comment on the possibility of requesting a waiver rather than using unorthodox measures, recalled that in the last meeting on Pakistan, there had not only been the warning to the authorities that this would be the "last, last chance for Pakistan." There had also been an admonition that there would be no waivers if performance criteria were to be missed. There had been strong statements in that regard, and it should not be surprising that the authorities resorted to unorthodox measures given their commitment to the program and in view of the circumstances under which it had been approved.

Mr. Donecker stated that the expectation was that a country would meet the performance criteria of a program. Nonetheless, if there were good reasons for a deviation from a program target, such as the ones that the staff had mentioned, it would be more appropriate if the authorities were open about that problem.

On the staff's statement that, in the future, inflation targeting might be more appropriate as a nominal anchor, Mr. Donecker considered that, with the stated intention of the authorities to change to an Islamic banking system, a shift to inflation targeting might have to be delayed, given Pakistan's limited administrative capacity and given the ambitious projects on the fiscal front, on the monetary front, and on banking stability.

The staff representative from the Middle Eastern Department (Ms. Eken) said that one of the primary concerns about the shift to an Islamic banking system was the status of preparations. Based on the work of the technical assistance missions that had gone to Pakistan, significant progress had been made toward setting up the legislative and accounting frameworks, and also toward preparing the documentation for the new financial contracts.

However, efforts were lagging in developing instruments for public finance, in training of employees, and in launching a public education campaign. Preparations by banks themselves varied. Some banks had established an internal process for reviewing their operations, while others had not yet started. In such circumstances, the agreed view among authorities and market participants was that the July 2001 target date for the full transformation of the system was not realistic. However, it was understood that significant progress could be made by that date, particularly with regard to putting together the necessary basic infrastructure. If sufficient progress was demonstrated by the deadline, it might be sufficient to satisfy the Supreme Court that its ruling was being implemented.

By July, the legal framework would be in place, the staff representative stated. Accounting systems would probably be in place by October 2001. The launching of public debt instruments should be possible toward end-2001, and the State Bank of Pakistan had indicated that by that time it would be able to reorient the supervision framework. It was unclear, however, what would happen to the existing debt. In Iran and Sudan—two countries with Islamic banking systems—the existing debt was not affected by the transformation of the system and was gradually phased out. Given the magnitude of Pakistan's domestic debt, it would be difficult not to follow a gradual course. Since Islamic financial instruments were real asset–based, it was necessary to develop and value the assets that would back these instruments. It would not be possible to complete that by the deadline.

Two technical assistance missions had focused on the shift to an Islamic banking system, the staff representative noted. The missions had assessed the progress made so far and additional measures needed to achieve an orderly transition. They had assisted the authorities in developing debt instruments, and had discussed the implications of the new system for the conduct of monetary policy during the transformation period. The Fund would stand ready to provide further technical assistance in the future, if that should be requested.

Mr. Kelkar wondered—given that a 1 percent increase in interest rates would reduce total interest payments by almost 4 percent from roughly 45 percent of GDP—what the implications were of the nominal depreciation on budgetary interest payments. The projection of a 4 percent reduction in interest payments seemed ambitious, given what had happened to the exchange rate.

On the difference of 5 percent between the interest rate in the kerb market and the official money market rate, Mr. Kelkar suggested that the absence of capital account convertibility might have been a reason for persistence of that differential, as the staff had suggested. However, persistent purchases in the kerb market might have also been a factor. Could the staff comment on the procedures used by the State Bank of Pakistan with regard to kerb market purchases, and was there any concrete program for their reduction? It seemed that kerb market purchases were a major source of instability in the economy.

The staff representative from the Middle Eastern Department (Ms. Eken) responded that exchange rate adjustments clearly would have an impact on the interest bill. However, developments in the exchange rate at present were not out of line with what had been assumed in the program. If there were severe deviations, then the program would need to be altered, but current exchange rate adjustments were in line with the program.

In addition to capital account restrictions, purchases by the State Bank of Pakistan were a factor contributing to the 5 percent spread between the kerb market rate and the official rate. Only licensed dealers were allowed to operate in the kerb market. The target set under the original program for the reduction in kerb market purchases had not been changed during the review mission.

Ms. Vtyurina asked the staff to comment on the credit increase and the condition of the banks that were exposed to the textile sector. On the issue of swaps, an explanation was necessary as to why the authorities did not use the normal process of accessing funds through the Central Bank's discount window if swaps were used just to provide liquidity and not to increase foreign reserves.

Mr. Mirakhor reiterated that the State Bank of Pakistan did not interact with money changers, but only with licensed foreign exchange market dealers.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael) said that the objective of the program with Pakistan was to integrate the informal foreign exchange market with the official market and to unify the exchange rates. In the case of Pakistan, the external account restrictions had fostered illegal transactions that would normally be conducted through official channels. There would always be a preference among those with external resources to exchange currency informally. In addition, the high transaction cost of dealing in small quantities of cash sometimes added to the premium. A 5 percent differential between kerb market and official rates was modest given the underlying concerns and compared favorably with other informal markets that had spreads of 10 to 15 percent over the official rate. The reason why the Central Bank found it necessary to intervene by purchasing foreign exchange was to encourage communication between the informal and official markets. Also, it did not make sense to leave resources in the kerb market idle if there was a need to increase official reserves—as long as those transactions occurred at current market-based exchange rates. Ideally, the staff would like the purchases by the Central Bank to be reduced. However, it should be noted that the purchases were not creating any distortions; if anything, the purchases reduced distortions.

The Central Bank dealt with authorized agents to exchange currency. In terms of sophistication and the volume of operations, those agents differed from authorized dealers in the official banking system, but those transactions were normal practice, which the staff encouraged not only in Pakistan but in other countries as well.

Foreign exchange swaps were generally a cause of concern when they implied a guarantee. In the case of Pakistan, there was no fixed exchange rate, and in terms of the monetary policy instruments at the disposal of the Central Bank, swaps were a legitimate instrument. However, if swaps were used too often, monetary aggregates would be distorted. In the fine print of the performance criteria, the staff corrected for the short-term foreign exchange swaps in the target of reserves because short-term swaps should not be encouraged as a way to meet reserve targets.

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

> First, the structural adjustment credit will be negotiated during the month of April. The structural adjustment credit covers three main headings: governance, growth, and the human development and social sectors. The Bank has been administering single tranche adjustment operations in Pakistan, which means that the Bank's Directors are approached with a full program with all measures already implemented.
>
> The area of governance is composed of the budget system and expenditure management. The Bank has an ongoing operation with regard to public accounts and public audits, which is also covered by the structural adjustment credit. The Bank is providing assistance in improving transparency and participation in accountability. The latter includes the devolution process, and for this particular area there is an institutional development grant to provide assistance to institution building, access to information by the general public, and civil service reform at the federal level, public enterprise level, and provincial level.
>
> In the area of growth, significant reforms have taken place in the oil and gas sectors, which are supported by an institutional development grant facility. Where there is an institutional development grant in operation, the Bank has been actively involved with the authorities in the design and implementation of reform measures over the past six to nine months.
>
> In the health, education, and social sectors, the Bank has a large operation. The social action program that was implemented for three years came to a halt, but now has been substantially restructured to accommodate the transformations taking place with regard to new initiatives by the current government and the devolution process. These activities will take into account the new arrangement in which the district level authorities will be in charge of certain parts of the delivery of services to these areas.
>
> Originally, banking sector reform was included in the structural adjustment credit, but at the request of the authorities and because of the financial requirements of this operation, it is now a separate project. It is designed as an investment project focusing on the process of preparation for the privatization of the nationalized commercial banks plus the liquidation of one of the specialized financial institutions. The two activities that the Bank will finance are the closing of branches and a large reduction in staff of 40 percent of the total current staff of the nationalized commercial banks. This amounts to 50,000 staff currently on the books and a reduction of about

22,000 employees. The majority of the Bank's financing will cover the cost of severance payments owed to terminated employees.

On public expenditures, the Bank produces an annual review of the development plan, which approximates investment expenditures, though it is difficult to distinguish between recurrent investment in development and nondevelopment expenditures in the Pakistani budget. This review is done together with the budget cycle, and the review for the next fiscal year will take place at the beginning of April 2001.

The Bank has increased work at the provincial level. A public expenditure review has been completed for the province of Punjab, and a review is expected for Sindh in the next fiscal year. This latter review will be particularly focused on the process of devolution. What has been learned thus far of this process indicates that a significant amount of the reductions in certain areas of public expenditure this year have been related to work in identifying misallocation and nonjustifiable expenditures, including expenditures in the social sector such as the existence of ghost schools and ghost teachers and ghost provision of health services. A labor-intensive and time-consuming survey was done at the district level to account for the existence of schools and the presence of teachers. As a result, the provincial governments have started to adjust expenditure to match the actual delivery of services.

With regard to devolution, the Bank is working with the National Reconstruction Bureau. Assistance has been provided through an institutional development grant. The Bank's staff have spent time in districts where elections have already taken place, and therefore the staff has been able to meet with counselors, mayors, the civilian administrations, and the representatives of the provincial governments. The process is full of dynamism. The Bank is very much aware of the issues regarding financial management, and have been working closely with the district education office and the district health officer along with their staff to reconcile the accounting systems and the recording systems with those of the provincial governments to ensure that resources under the social adjustment project were reaching intended objectives.

Mr. Le Fort asked whether the ongoing operations, along with other projects, were subject to a future Fund-supported program for their continuation, or whether they were independent.

The staff representative from the World Bank (Mr. Peñalver) replied that there was only one program of economic reforms in Pakistan, while both institutions engaged in the areas of their respective competencies.

Mr. Junguito asked if fiscal decentralization and transfers of fiscal responsibility, along with the devolution process, would be discussed by the Fund's staff. The question on how to design those policies was complex and their implementation difficult. It had to be clarified whether the World Bank or the Fund would be primarily in charge of their design and implementation.

The staff representative from the World Bank (Mr. Peñalver) answered that fiscal decentralization and the devolution process were being designed and implemented jointly with the Fund. The Bank was providing technical assistance.

The staff representative from the Middle Eastern Department (Ms. Eken) noted that the Fund had not received a request for technical assistance in the particular area of fiscal decentralization and devolution. However, if such a request were made, the staff would be able to provide assistance together with the World Bank.

Mr. Donecker commented that it was promising that the Fund and the World Bank seemed to be working in the same direction together with the authorities.

Mr. Shaalan remarked that, with regard to fiscal decentralization and devolution, it was worrisome that the Fund might get involved in areas where it had no expertise or resources.

The Acting Chairman remarked that the World Bank had the lead with regard to the issues of transfer of power, decentralization, and public expenditure management. The Fund was not indifferent to those issues because they had considerable macroeconomic and fiscal implications.

Mr. Chelsky noted that in Appendix II of the staff report, various aspects of the provincial fiscal finances and devolution initiative that are of interest to the Fund seemed adequately articulated. The Appendix circumscribed the Fund's interest quite well, leaving little reason for worry that the Fund would become involved in areas where it had no mandate or expertise.

Mr. Sdralevich made the following statement:

> At the outset let me thank the staff for their well-prepared report and Messrs. Mirakhor and Ahmed for their informative preliminary statement. Both documents depict a positive picture. Indeed, we have the impression that the authorities are finally beginning to build some momentum, both in structural reform and governance, as exemplified by the resolution of the IPP issue, and in macroeconomic policy management. Therefore we support the proposed decisions.
>
> We would like to concentrate our remarks on the areas of monetary policy, fiscal policy, and the external financing gap.

It is appropriate that monetary policy is kept tight to counter adverse pressures on the exchange rate and reserves. We broadly agree with the staff's opinion with regard to technical aspects, so let me just remark here that we strongly disapprove of the "unorthodox" methods employed to reach the NDA target of end-December 2000. Like others, we see this target as having been substantially missed. As it was discussed earlier, perhaps granting a waiver would have been better justified, especially considering that the main cause of the deviation was represented by unforeseen developments in money demand.

In a context of a satisfactory fiscal balance, we have two major sources of preoccupation. First, mainly because of weaknesses in tax administration as remarked by the staff, revenues are not performing as envisaged. This has led to the breach of a quantitative performance criterion. As other Directors noted, the overall fiscal result had to be obtained by cutting expenditures, including so-called "low-priority" development spending, as remarked by other Directors. Clearly, the problem lies in strengthening revenues, and this should be done directly with a more vigorous application of the existing instruments and of the contingency plan, and indirectly through the envisaged structural reforms affecting tax administration. While setbacks are understandable given the difficulty of the task, it is essential that these reforms continue, and we encourage the authorities to stick to the schedule agreed with the Fund.

Second, the process of fiscal devolution may pose serious problems both from the point of view of controlling expenditures and revenues, and from the point of view of statistical reporting. These have been areas of vulnerability in the past for Pakistan, and, like others, we are afraid that by pushing ahead too strongly the devolution process both could be, and possibly already are, under excessive pressure. Our worries stem in particular, on one side, from the lack of institutional capacity to implement the reforms, and on the other, from the not yet complete plans for the further stages of devolution—for example, in relation to the revenue-sharing formula and the establishment of an equalization fund. With regard to Mr. Shaalan's comments, we believe that the Fund is also interested in the devolution process because of its implications for fiscal discipline, so there is room for work from both the Bank and the Fund.

External financing remains a problem in the medium term. We would like staff clarification on the coverage of the financing gaps, particularly in the fiscal year 2001–02. If needed, we would like to see a greater role for PSI, consistently with our position on occasion of the approval of the program and with the efforts of Paris Club creditors.

Lastly, let me conclude by agreeing with the staff on the challenges posed to monetary policy by the forthcoming Islamic reform of the financial sector. The authorities should work in a timely manner so as to preserve in the new environment their effectiveness in the operation of economic policy, especially monetary policy. I am encouraged by the words of Mr. Mirakhor today and by the explanations of the staff, which show a constructive approach. This is needed, as noted particularly by Mr. Yoshimura and Ms. Saito, given that uncertainty in the monetary and financial environment could have the unwanted effect of discouraging investors.

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

Mr. Zurbrügg made the following statement:

I welcome the Pakistani authorities' achievements in stabilizing the macroeconomic situation and moving forward in several areas of structural reforms since our last discussion. It is unfortunate that exogenous shocks such as the recent drought and the deterioration of the global outlook are making the authorities' task of economic management even more difficult than it already is. The staff paper clearly shows that the situation remains fragile and the risks and vulnerabilities have not diminished. A crucial first step in reducing these vulnerabilities is the determined implementation of the SBA-supported program. Like Mr. Shaalan and Mr. Himani, I think it is particularly important that not only the letter but also the spirit of the program is adhered to. Both in the monetary and fiscal areas, economic management has been characterized in part by ad hoc short-term measures to achieve program goals. While I warmly welcome the authorities' commitment to achieving these goals, particularly in the fiscal area, the developments over the past months are not sustainable.

Revenue mobilization is a cornerstone of the authorities' program. Given the urgent need to increase the level of public services, particularly in the social sector, I was disappointed by the slippages that have occurred with respect to the tax revenue targets. The targets under the program were ambitious. But they were in line with the urgency with which the pervasive problems of tax administration have to be resolved. It is very unfortunate that the authorities have had to compress spending to compensate for lower-than-expected revenues. I share the concern about shortfalls in poverty-reducing expenditures in the first half of 2000–01. These shortfalls are very regrettable and should be avoided in the future. However, the comments by the World Bank representative do provide some comfort in that these shortfalls did not have a full impact on the delivery of social services.

I fully agree with the staff that the fiscal stance should not be weakened, as the debt burden is high and the balance of payments situation is subject to major vulnerabilities. While I appreciate the authorities' short-term action plan to improving tax administration with the help of technical assistance of the Fund, this quick fix should under no circumstances lead to a postponement of the longer-term measures. I note the staff's comment that the fundamental reform of the CBR has remained behind expectations. Like Messrs. Collins and Taylor, I am concerned that there seems to be resistance from the CBR to the reform efforts.

With regard to monetary policy, I agree with the modified target for NDA to take into account the higher-than-expected currency demand. Given the importance of achieving the critical reserve targets under the program, I tend to agree with the staff that monetary policy should have been tighter. Given the large uncertainties regarding money demand and its impact, in my view it is difficult to judge if the modified program is appropriately tight. With regard to the authorities' efforts to increase the flexibility of the exchange rate, I welcome the further steps that have been taken, but I share Mr. Lushin and Ms. Vtyrina's concerns, particularly with respect to the interventions on the kerb market.

On structural reforms, the settlement of the tariff dispute between HUBCO and WAPDA was a milestone. The authorities will hopefully be encouraged by the success in structural reforms in the energy sector and proceed swiftly with further reforms. I urge the authorities to make every effort to work out and implement comprehensive reforms in the key public enterprises. Besides improving the management and the financial situation of these enterprises, governance issues need to be tackled forcefully.

On governance more generally, I welcome the prominent role the authorities are attributing to this crucial element of the reform program. I fully agree that the devolution of power to district level authorities and local councils is an important pillar of the governance strategy. However, I am extremely worried that the unduly compressed timetable for the introduction of devolution will have serious negative repercussions on fiscal management. Our own experience has shown the complexity of such an endeavor, even in an environment of well-developed institutional capacities. I am not at all comforted by the staff's conclusion that the government "seems to have found a workable solution for the next budget and a transitory arrangement for the next couple of years."

To conclude, I hope this Board discussion can alleviate the authorities' concerns noted by Mr. Mirakhor concerning the Board's alleged inflexibility on granting well-justified waivers for performance criteria. I support the proposed decision and wish the authorities perseverance in their efforts to tackle the multiple challenges they are facing.

Mr. Shaalan commented that distinctions should be made between the process of devolution, laying the groundwork for introducing devolution, and the impact of devolution on the outcome of fiscal policy. Only the effects on fiscal policy were within the Fund's domain.

Mr. Mirakhor noted Mr. Donecker's assurance that waivers would be considered if justified in the case of Pakistan, and emphasized that this should be noted in the record. In the last Board meeting on Pakistan, there had been a blanket admonition that waivers would be accepted should performance criteria not be observed.

Mr. Chelsky made the following statement:

> I appreciate that staff have acknowledged the underlying structural problems. This explicit acknowledgment allows us to address macroeconomic imbalances that have destabilized and prevented the economy from achieving a faster and more equitable growth path. I also join Ms. Lundsager in welcoming the authorities' decision to publish this review.
>
> The staff have pointed out where performance has fallen short. It is welcome that the authorities appear to acknowledge most or all of the areas that the staff has pointed out. The authorities have also made a good start on the program. In the interest of brevity, I associate myself with the statements of Messrs. Shaalan and Himani, particularly with regard to revenue policy, and I have comments on a few specific issues.
>
> On the issue of devolution, we welcome the effort which appears to be part of a much broader strategy to reform the fiscal architecture, and it should be acknowledged as such. However, as others have noted, there are serious risks. It is important that the staff review emphasizes the need to obtain better fiscal data. Its quality and transparency has been weaker than envisaged, and improving on that will be one of the most important challenges in the near term. I therefore urge the staff to raise the profile of this issue in the period ahead and to make sure that it is well understood that addressing the problems associated with devolution and fiscal reforms should be high on the list of priorities.
>
> The staff note that revenue shortfalls are primarily the result of disappointing sales and income tax receipts. The two areas should be differentiated. The staff note that the sales tax revenue is below projection because of lower-than-projected imports. The authorities should be responding to exogenous shocks, but the time frame seems too short to make an effective response. Therefore, the shortfall in sales tax revenue can be accepted in light of the remedial measures that are identified in Paragraph 16. However, the shortfall in income tax revenue is worrisome, and more information about what measures are being taken to address this problem would be welcome. We also support the staff in their call for intensified efforts to make the agricultural income tax fully operational as soon as possible.
>
> The shortfall in poverty reduction expenditures is a disappointment, but it should be noted that, at the last Board meeting on Pakistan, the World

Bank representative said that there were serious capacity constraints with respect to spending on health and education. It is definitely appreciated that there are constraints of governance and accountability, and there is a need to ensure that spending in these areas is effective. More information on measures to improve the situation would be welcome.

On the issue of targets and contingency measures, it is not clear what contingency measures are envisaged to achieve the next review target if the program goes off track. Nor is it clear if the staff are confident that the year-end development expenditure target can be achieved. If further revenue slippages occur, requiring expenditure cuts to avoid missing another deficit target, then the defense budget should be cut in the future. The authorities should plan in advance for contingency measures along these lines. The timing of a possible PRGF arrangement would need to coincide with a marked reallocation of public resources away from military purposes toward greater investment in human capital.

Mr. Ondo Mañe made the following statement:

First of all, I would like to thank the staff for the well-written report and Mr. Mirakhor and Mr. Ahmed for their helpful preliminary statement. Economic performance in Pakistan during the first half of fiscal year 2000/01 is broadly in line with the program objectives, despite lower-than-envisaged GDP growth and a shortfall in revenue collection. Inflation was lower than projected, and the current account deficit was somewhat contained. Despite progress in implementing important reforms in different areas, the Pakistani authorities need to carry out further structural reforms in order to obtain the full benefits of the program and to reach their objective of reducing poverty over the long term. I agree with the staff appraisal and support the proposed decision.

Fiscal policy is one of the key elements of the program under review, and the short-term action plan implemented by the authorities to improve tax administration is welcome. This action plan addresses problems related to revenue performance. Also, the Central Board of Revenue (CBR) has implemented measures to improve its administration. These measures will help Pakistan achieve medium-term fiscal sustainability.

On the expenditure side, I am encouraged by the improvement on fiscal control as well as the efforts of the authorities aimed at achieving the fiscal deficit target through cuts in expenditure on low-priority projects. Here, I share the staff's and other Directors' concerns that poverty reduction expenditures could be adversely affected.

Another important issue is the fiscal decentralization resulting from the devolution of power to local institutions. Although I recognize the advantage of this policy for expenditure management and local service delivery, I would recommend that the authorities be cautious in implementing this policy, particularly with regard to governance and national macroeconomic development. On these matters, I would like to associate myself with Mr. Junguito's concerns. I appreciate the authorities' measures to fight corruption that include the establishment of the National Accounting Bureau with power to investigate and prosecute corruption cases in the civil service. Improving governance at the local level will require strengthening of the administrative capacity and control authority at the local level. A well-financed and decentralized judiciary system is also necessary to improve good governance at the local level.

The civil service reform should require a system of promotion based on merit, and the introduction of a personnel evaluation schedule that is without political interference to ensure a more transparent and efficient system. Civil service reform, to be successful, will require reducing wages and salaries. Further staff comments on the salary structure and its impact on the budget would be welcome.

The authorities are to be commended for the steps taken to improve the situation of the major public enterprises and the regulation of the energy sector through the increase of royalties to market-based pricing in this sector. This will create increased private sector activity and induce more successful privatization of public enterprises.

Authorities should accelerate measures to strengthen the fiscal position of the banking system. Competition between banks should be increased and international banking operations liberalized. In this regard, participation in a Financial Sector Assessment Program (FSAP) review will help the authorities to assess the need for technical assistance.

With these remarks, I support the proposed decision and wish the Pakistani authorities success in their efforts ahead.

Ms. Steinbuka made the following statement:

Last November this chair supported the authorities' request for a Stand-By Arrangement, but emphasized the risks associated with the program. I welcome progress achieved under the SBA. However, like previous speakers, I must admit that serious risks remain, which have been well described by the staff and emphasized by Directors.

Revenue collection remains weak. A recent report from Oxford Analytica states that tax evasion in public enterprises continues to be high. Undoubtedly, there is significant domestic hostility to the government's attempts to strengthen tax administration. We welcome the authorities' determination to eliminate weaknesses in tax collection. Strengthening tax administration capacity is absolutely critical, and I urge the authorities to make further firm steps in this direction.

A shortfall in tax revenues has been compensated by expenditure cuts. However, cutting expenditures in order to meet fiscal targets should not become a tradition. Expenditure cuts depend on changing priorities. I am especially concerned that instead of military spending, public investment in infrastructure or human development will be reduced.

On monetary policy and related risks, I agree with Mr. Sdralevich's comments. Foreign investor confidence remains low. Uncertainty on the issue of the rules and principles of Islamic banking reduce confidence and may lead to capital flight. Foreign investment is limited because of the slow privatization process and the unfavorable business environment. Without sizable investment, it would be problematic to diversify exports. The authorities are only beginning the way to diverse growth and prosperity.

While a lot of unsolved problems remain, I commend the authorities for their efforts to implement the policies under the program and support the proposed decision.

Mr. Cho made the following statement:

The manner in which the authorities are meeting the monetary target does not seem to have been reasonable in terms of honesty and transparency. Nonetheless, it also seems that it would have been justified for the authorities to ask the Board for a waiver, as Mr. Donecker has said, rather than resorting to unconventional methods. Given what has been said thus far, I would like to suggest the reason why an increase in monetary demand does not necessarily result in higher inflation. Even if narrow money supply increases, there would not be a substantial impact on inflation as long as currency circulation decreases. In the case of Korea, inflation has been under control, even with increases in the base money just a few months after the foreign exchange crisis at end-1997. At that time there was uncertainty about the future of the financial system, and market participants preferred to hold their currency. The reserve circulation increased, and yet there was little impact on inflation.

The monetary situation in Pakistan during the second half of last year appears to be similar to the Korean case. All of the three causes for stronger money demand mentioned in the staff report seem to be related to the encouraging economic performance. If people prefer using cash to avoid tax, they are likely to keep it at home, and the current monetary circulation balance is usually low in rural areas because sophisticated financing services do not tend to be available in that area. Rupee demand by Afghanistan and its refugees in Pakistan is likely to increase from a safety-seeking motive rather than for the purposes of immediate spending. Thus, the authorities could argue that missing the monetary target may not affect the underlying principles of the program. If this argument can be accepted, the staff could have redesigned a reasonable performance criterion for the future in a manner similar to what was done for labor reform.

I understand Mr. Mirakhor's points that the authorities were pressured to meet the monetary target, especially given the statement issued by the Board in the last meeting. Nonetheless, it may be better for the sake of transparency and sincerity to fulfill the program's conditionality and enhance the programmed reserves, and to admit where policy implementation falls short of the target. It also exemplifies a strong case which the Board can draw upon for allowing waivers for good reasons.

We have no objection to the completion of the first review of the SBA and the request for the waiver and the modification of the performance criteria.

Mr. Hendrick recalled that Mr. Junguito had suggested the need for automatic adjusters for exogenous factors like a change in money demand in assessing adherence to performance criteria, and noted that the staff mentioned that they designed adjusters for the performance criteria to deal with exogenous factors. However, in footnote 2 in the table on quantitative performance criteria, the adjustment had been designed to avoid altering the NDA target. Pakistan had particularly volatile money demand, and in this particular case, the Central Bank should be allowed, if needed, to change the reserve bank rate to allow for an increase in the ceiling of NDA. If money demand was so volatile, it would seem that the adjusters should be designed to take effect in the other direction.

Mr. Oyarzábal made the following statement:

It is important to encourage the authorities to continue their efforts toward fiscal reform. Although the fiscal stance seems appropriate at this time for medium-term fiscal sustainability, emphasis should be maintained to avoid shortfalls in fiscal revenues in the future.

Second, the authorities should look carefully at the effects of cutting development expenditures, and I thank the representative from the World Bank for clarifying the approach that has been taken on this issue.

Third, I welcome the process of fiscal decentralization. It should favorably influence the efficiency of public expenditures, yet we urge the authorities to keep a watchful eye for complications in fiscal management.

Fourth, the staff's views relating to the coordination of monetary and exchange rate policy should be carefully heeded. It would seem appropriate to expect that a floating exchange rate should enhance monetary management.

Careful attention should be given to the unorthodox measures taken to reach monetary targets. I think they were extremely useful, in focusing and giving a different perspective to this issue.

Fifth, we welcome the thrust of structural reform agenda. It addresses tax administration, energy, the financial sector, and the issue of governance, and I share the staff's view that improving governance has been a central element throughout the reform agenda.

In closing, we support the proposed decisions and hope that an early negotiation and a program supported by a PRGF can be readily achieved. Also, I would like to give recognition to the authorities for the publication of the documentation.

Mr. Kiekens made the following statement:

A more rapid reduction and total elimination of the deposits of the Central Bank with Pakistani banks abroad should be undertaken. The plan and the suggestions made by the staff point in the right direction but should be more ambitious.

Second, transparent and faithful cooperation between the staff and the authorities is crucial. It is not appropriate to artificially meet performance criteria that have become inappropriate, not to mention that meeting criteria artificially is counterproductive.

Third, the Central Bank should stop intervening in the kerb market. The staff said that the margin of the spread between the kerb market and the official market is quite low compared with other countries where there are capital controls. But that can also indicate that some of the capital outflows, which are not authorized, flow through the official markets and not through the parallel market, lowering the spread between the two markets. It would be distortionary if the Central Bank buys at a premium in the nonofficial market and then sells in the official market. That would constitute a subsidy of current transactions and, even worse, a subsidy of capital outflows at the subsidized rate, and the same capital could flow back in through the nonofficial kerb market.

Fourth, on the adjuster for net international reserves that is designed to discourage the use of foreign exchange swaps, these adjusters should be included in the notion of net international reserves in all programs and not only as a specific adjuster in the case of Pakistan. If a specific adjuster is used in the case of Pakistan, that would imply that in other countries the Central Bank can meet the NIR target by pursuing foreign exchange swaps.

The fiscal revenue shortfalls are a source of concern in Pakistan. Contingency measures should be at hand in the case of future shortfalls, which should require reduction of military expenditures. The staff should also pay close attention to the emergence of unidentified expenditures equal to 0.5 percent of GDP. The social situation in the country has not improved since the time of the last review. Mr. Mirakhor and Mr. Ahmed make the case for an early start of negotiations on a PRGF-supported program. Undoubtedly the prospects for such an arrangement would be more promising if the authorities could reduce the size of unproductive expenditures and increase expenditures in the social area.

Directors often call, and rightly so, for strong determination by the authorities to implement programs. At this juncture of the meeting, it is fully appropriate to express my gratitude for the commitment, determination, professionalism, and dedication that the staff and Mr. Mirakhor have demonstrated in working with the Pakistani government in difficult times to help them advance their work to improve the living conditions for the Pakistani people.

The staff representative from the Middle Eastern Department (Ms. Eken), in response to questions and comments from Directors, made the following additional comments:

On export performance, diversification, and the related policies, during the past 20 years, the share of primary commodities in total exports declined from almost 40 percent to 13 percent. There was an increase in diversification as a result of this shift, primarily toward textile exports. There has not been much diversification into other manufactured goods; 75 percent of all manufacturing exports are textile products.

The two major policies to improve export performance and increase export diversification are the flexible exchange rate policy and trade reforms to reduce the anti-export bias in the system. Both of them are integral parts of the program. It will take time to assess the impact of these policies, but the first half of this fiscal year has been extremely encouraging. The performance of nontraditional exports was better than expected under the program, and they performed better than any other export category.

On the income tax, measures are planned and incorporated into the short-term action plan to improve the income tax performance. Most importantly, more audits are to be undertaken and collection efforts by the tax administration are to be intensified, focusing on the largest taxpayers. The next important step will be the major overhaul of the income tax system which would become effective as of July 2001, with the next budget.

The civil service salary reform is planned for next year, which is expected to have an impact on the recurrent expenditures for next year.

However, it should be noted that the change in the salary structure will be combined with some organizational restructurings and downsizing. Thus, it is difficult at this stage to know what precisely the impact of the reforms will be.

On the external financing gap for the next year, at present there is a gap of about US$2 billion. If there is a Paris Club rescheduling in terms comparable to the one that took place in 2001, that would cover about $1 billion of the financing gap. Based on discussions with the World Bank and ADB staff, about half of the remaining gap could be covered from other international financial organizations. The remaining half billion could be financed from various sources, including the Fund and the private sector.

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

It was indicated earlier that the staff proposed using adjusters for the performance criteria benchmarks for the period ahead to avoid any recurrence of the unorthodox measures used by the authorities for meeting the December performance criteria. The staff do not consider the unorthodox measures to be appropriate. Perhaps the circumstances compelled the authorities to resort to these measures to make sure that they observed the performance criteria. Nonetheless, the staff does not agree with the suggestion that performance criteria should be adjusted any time there is an increase in velocity. Such a policy is tautological: It is never known whether an increase in real money balances is due to an increase in money demand or an excess increase in money supply. Adjusting automatically would imply that the monetary performance criteria would not be binding. However, to the extent the staff is convinced that there is an increase in the demand for money, the performance criteria will be adjusted ahead of time. This has been done for March.

Mr. Kiekens made pertinent observations about the money market, with which the staff have no problems, particularly with regard to the kerb market. The intention of the staff is to remove distortions and to unify the official and the unofficial market. Capital account controls encourage the development of an informal market. To integrate resources back into an economy, either the informal market must be legalized or illegal transactions must be ignored.

In countries like Pakistan there are other illegal activities that for fiscal or other reasons may not be channeled through the banking system which, in a sense, provide additional resources. Any purchases of foreign exchange from this market do not finance capital outflows. If anything, they take funds out that would otherwise have found their way out of the country, which can be useful to the extent that it helps rechannel resources back to the official system. Whether that implies any exchange rate subsidies would require examination of the details. The general objective, though, is to reduce the distortions in the differential by removing the incentives for illegal activities while gradually unifying the markets.

On the definition of the net international reserves, there is a need to specify the adjusters explicitly because Pakistan does not adhere either to data standards or the SDDS. Under the SDDS, all of these adjusters are implicit, so the definition of whether there are usable reserves already takes into account these adjusters. The staff specify adjusters for Pakistan because the manner in which transactions involving foreign currency deposits or short-term swaps are treated may result in distortions. There is a discrepancy that should become more narrow over time between what the authorities announce as official reserves and what the staff consider as usable reserves.

On fiscal decentralization and devolution, the staff agrees with Mr. Shaalan that the reforms on the administrative side go beyond the core areas of the Fund. The fiscal implications and the transfer rules between the local government and the central government is of interest to the Fund because it affects the central government. Fiscal decentralization may be part of Fund conditionality to the extent that the measure affects not only the effectiveness of service delivery and is crucial for poverty reduction, but also because it affects governance. The staff will continue to collaborate with the World Bank to receive their input. In general, the staff will approach these issues under the umbrella of the implications of service delivery, governance, and major fiscal implications.

Mr. Junguito considered that many countries have done well with an automatic adjuster that allowed for certain movements linked to a specific item, like the demand for cash. A strict rule which might endanger a program should not be allowed.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael) replied that in general the performance criteria were defined as a fixed amount and not as a range. In the circumstances of Pakistan, where the authorities' intention was to show strict adherence to the program targets, it was preferable to have the performance criteria presented in as simple a form as possible to avoid unnecessary complications. In the discussions with the authorities, some agreement should be established on the level of underlying money demand three months ahead of time to avoid unnecessary complications.

Mr. Zurbrügg considered that it had often been mentioned that conditionality was complicated by circumvention of performance criteria. In the current discussion, the staff said that the authorities had been open and transparent with regard to the unconventional methods used to meet the performance criteria. The reasons for the measures were also clearly stated by Mr. Mirakhor. It was surprising that adjusters were necessary for the second round of the program; the authorities should be fully cognizant of the performance criteria to prevent slippages from occurring again.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael) remarked that the adjusters had been designed in the spirit that many Directors had endorsed: It would be unwise to have recourse to unorthodox measures. The authorities agreed to have these adjusters in the performance criteria. There was no lack of ownership, and there was agreement to close the loopholes. In the future, if there was a shock in terms of a demand for money, then a waiver might be requested.

Mr. Yoshimura said that it was not evident that the flexible exchange rate and trade liberalization helped the diversification of exports, although that might be a temporary phenomenon. Export diversification was important to avoid supply and demand shocks and to overcome entrenched structures of export production. However, the link between a flexible exchange rate and trade liberalization policies and the diversification of exports was not clear either in a theoretical sense nor an empirical one.

The staff representative from the Middle Eastern Department (Ms. Eken) remarked that macro- and microeconomic policies were focused upon in equal measure. The authorities undertook microeconomic policies, such as promoting the marketing of their export goods and services. Structural reforms and private sector development, among other factors, helped the diversification of the economy and thus diversification of the exports in the long run.

Mr. Mirakhor made the following concluding statement:

> The depth and extent of the authorities' ownership is the most distinctive feature of this program. The strength of ownership will be reflected in the implementation of the reforms. The World Bank is much more concerned with structural adjustments and reforms, and perhaps a bit more convinced than the Fund that there is genuine ownership.
>
> On military expenditure, both Mr. Kiekens and Mr. Chelsky referred to the level of spending and not the rate of spending. The data show that over the past few years, military spending as a percentage of GDP in Pakistan has declined in real terms. Also, the exchange rate depreciation forced a counterpart reduction of military spending abroad. Further, a proper judgment cannot just consider this country in isolation when military spending in the surrounding region increases by 28 percent per year. It is difficult for the authorities to convince their people that the country must remain more or less defenseless. I appreciate and have always appreciated the emphasis of Board members and the Fund in general on nonproductive spending, but it is important to be cognizant of some ground realities when one makes a suggestion to that effect.
>
> Pakistan now has debt indicators that are higher than the HIPC as a group, yet they have a Fund-supported program with general resources. Of course, this is more expensive. When asked to perform preconditions under a SBA, they deliver. Yet the Fund, either through preconditions or suggestions, sets preconditions in such a way that the program cannot move forward to a

concessionary facility unless military spending is reduced. Questions surrounding military expenditure are not made in a vacuum. Under the circumstances, one should focus on the rate of increase, and that is what the authorities are doing.

The Bank and Fund staff have considered at considerable length responses to the Directors' questions and comments. It remains for me to thank my colleagues for their interest, advice, and support. Their views will be faithfully transmitted to my authorities. Also, Mr. Donecker commended the close cooperation between the World Bank and the Fund, and I want to join him in this appreciation in the case of Pakistan. It has been indeed a very close cooperation. I would also like to extend my authorities' appreciation to the Chairman, Mr. Barro Chambrier and his staff, and to Mr. Nichimuso and his staff for all the hard work over the past 10 months. Finally I extend both the thanks and appreciation of my authorities to Miss Eken for all of her efforts over the last two years, as she is moving to a new assignment. I wish her all the best.

Mr. Chelsky noted that in the first discussion for the present program with Pakistan, it was acknowledged that many of the countries in the region had massive development needs, and that it was unfortunate that those countries had military allocations at a level comparable to expenditure on social development infrastructure. Priorities were clearly out of line. What was needed was a regional solution, and it was important that the staff considered that perspective in future reviews and Article IV consultations with other countries in the region. It was difficult to justify the allocation of scarce concessional resources when the relative priorities within a country were such that defense spending overshadowed spending on human development by a significant degree. Part of the answer was to reduce the level of military spending and allocate more toward social development. Such change would take time, and it should be acknowledged that the rate of military spending was important.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the encouraging macroeconomic performance and the progress in the implementation of structural reforms, noting that inflation, the balance of payments, and the fiscal balance were better than expected, and that most performance criteria and benchmarks have been observed. The downward revision of the real GDP growth projections for the current fiscal year is reasonable in view of the adverse impact of drought, slowing external demand, and higher fuel prices. Directors stressed that the economy must achieve stronger growth if poverty is to be reduced: Sustained implementation of firm demand management policies and adherence to the structural reform agenda will be essential to consolidate the achievements so far and lay the foundations for sustained high growth. Directors noted the considerable downside risks to the program and emphasized the need for contingency measures.

On fiscal policy, Directors regretted that the revenue performance had been below target. They welcomed the short-term corrective measures being taken to improve tax administration, but emphasized that a sustained, long-term effort is needed to broaden the tax base and strengthen tax administration further. They welcomed the reforms being undertaken in this area. Directors welcomed the efforts to restrain expenditure, but were concerned by lower-than-expected development and poverty-related spending. They stressed the need for more effective poverty reduction efforts.

Directors commended the authorities' commitment to make governance a pillar of the reform agenda in order to improve the management of public resources and the business environment. They noted that the devolution plan, while desirable for better accountability and service delivery, is not a complete solution in itself and will pose serious risks for fiscal management. These risks need to be urgently addressed.

In view of the low level of foreign reserves and the need to keep inflation low, Directors expressed concern that the underlying monetary stance had been more expansionary than envisioned. They strongly advised the authorities to keep monetary policy appropriately tight through interest rate adjustments and open market operations. They called for careful coordination of monetary and exchange rate policies, and supported the move to a genuinely market-determined exchange rate. In this regard, they welcomed the authorities' intention to discontinue the sale of foreign exchange in the interbank market, except for smoothing operations, and to sharply reduce, and preferably discontinue, purchases in the kerb market.

Directors supported the authorities' efforts to improve the soundness and efficiency of the banking system, as well as their request for a Financial Sector Assessment Program (FSAP). They noted that preparation for the transition to a financial system based on Islamic principles has begun and welcomed the authorities' intention to implement carefully the necessary preparatory steps, which will be essential to ensure an orderly transition.

Directors commended the authorities for resolving the disputes with independent power producers, deregulating the energy sector, and adjusting electricity tariffs. They encouraged the authorities to continue implementing the restructuring and privatization program and other energy sector–related reforms.

Directors noted the progress made in addressing data-related issues and in improving fiscal and financial accountability and transparency. They encouraged the authorities to maintain the momentum gained in these areas and accelerate efforts to address data issues at provincial levels. They welcomed the authorities' intention to publish the LOI and the staff report.

A number of Directors expressed the hope that Pakistan would work with the staff to prepare a successor medium-term program that could possibly be supported by the Fund under the PRGF. A few Directors noted, however, that continued good performance under the current program and stronger and deeper reforms in public finance, expenditure restructuring and transparency, and governance will be essential to establish a sound basis for such a program.

The Executive Board took the following decision, with one abstention from Ms. Lundsager:

1. Pakistan has consulted with the Fund in accordance with paragraph 3(d) of the Stand-By Arrangement for Pakistan (EBS/00/230, Sup. 1, Rev. 1, 11/28/00) and paragraph 65 of the memorandum attached to the letter from the Minister of Finance and Economic Affairs and the Governor of the State Bank of Pakistan dated November 4, 2000, to review program implementation, modify performance criteria for end-March 2001, and establish new performance criteria.

2. The letter from the Minister of Finance and Economic Affairs and the Governor of the State Bank of Pakistan dated March 18, 2001 (the “letter dated March 18, 2001”), together with its attached Memorandum of Economic and Financial Policies (the “Memorandum”) and Technical Memorandum of Understanding (the “TMU”), shall be attached to the Stand-By Arrangement for Pakistan, and the letter from the Minister of Finance and Economic Affairs and the Governor of the State Bank of Pakistan dated November 4, 2000, shall be read as supplemented and modified by the letter dated March 18, 2001.

3. Accordingly, the Stand-By Arrangement for Pakistan shall be modified as follows:

(a) The performance criteria referred to in paragraphs 3(a)(i), (ii), and (v) for end-March 2001 and the performance criteria referred to in paragraphs 3(a)(i) to (x) for end-June 2001 shall be as set out in Table 1 attached to the memorandum and further specified in the TMU.

(b) Paragraphs 3(b)(x) and 3(b)(xi) shall be added to read as follows:

“(x) by June 30, 2001, preparation of an IAS-compliant reporting format and comparable IAS financial statements for the State Bank of Pakistan for the previous year ended June 30, 2000, or

(xi) by June 30, 2001, reduction of the State Bank of Pakistan’s deposits with Pakistani banks abroad to a maximum of US$200 million and formulation of a plan to further reduce placements with Pakistani banks abroad; or"

4. The Fund decides that the first review contemplated in paragraph 3(d) of the Stand-By Arrangement for Pakistan is completed and that Pakistan may make purchases under the arrangement, notwithstanding the nonobservance of the performance criteria on CBR revenue for end-December 2000 and the petroleum price adjustment for December 15, 2000, (i) on the condition that the information provided by Pakistan on the implementation of the measures specified as prior actions in Table 3 attached to the memorandum is accurate, and (ii) on the further condition, with respect to the purchase subject to the performance criteria specified above, the information provided by Pakistan on performance under these criteria is accurate. (EBS/01/39, 3/19/01)

Decision No. 12460-(01/32), adopted
March 30, 2001

2. INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE—PROVISIONAL AGENDA

The Executive Directors considered a draft provisional agenda for the Third Meeting of the International Monetary and Financial Committee (EBD/01/31, 3/15/01).

Mr. Shaalan made the following statement:

I recall that last year when the Board met on this subject, it was my clear understanding that agreement has been reached that in order to make the meetings more effective, we needed to limit the number of topics for discussion by the IMFC. Therefore, my comments will mainly attempt to propose changes in the spirit of restoring both brevity and focus to the agenda topics, taking into account that we have agreed that we need to stick to the core activities of the Fund.

No doubt, the global outlook and vulnerabilities in the global financial system should be the main area of discussion. That would be item 2. Under this heading, I would propose that we add item 3, first bullet under the first arrow, namely, "Strengthening the IMF's Focus on Financial Markets and Crisis Prevention." Discussion of this item would appear to me to belong in a discussion addressing the weakening world economy.

"Streamlining Conditionality and Strengthening Ownership" should be another major topic. Here, I note that the discussion should be more in the nature of a progress report to the IMFC, and we should not unravel what the Board has already agreed upon. We fully support the initiative of the Managing Director in this area. This chair does not subscribe to the view that the Fund could take responsibility for carrying out functions that fall outside its core activities merely because for one reason or another the relevant institution cannot carry out the function. To my mind, this is a dangerous course to pursue and there were many reservations expressed by Directors on this score.

The third area which could be part of the agenda for a joint meeting, and I have no problems with that joint meeting between the IMFC and the Development Committee if a decision is made to hold such a meeting, could cover item 4, “Fighting Poverty and Strengthening Growth.” However, I would like to know what is going to be covered under bullet four of item four, namely “Supporting Postconflict Countries.” Do we have a plan backed by financial resources that goes beyond what has been done before? If we do not have specific proposals, we should consider mobilizing support for this endeavor prior to putting it before the Committee.

On “Private Sector Involvement in Crisis Prevention and Resolution,” we have little to add on this subject. I therefore do not see a need for including it on the agenda, unless we have something new to add.

On “Combating Financial Abuse and Money Laundering,” we continue to believe that the Fund has neither the expertise nor the resources to handle this area effectively. Of course, these can be acquired, but let us first estimate the cost and dimension of this involvement, including the needed symmetry in the treatment before we proceed. I mean by the dimensions of that endeavor the inclusion of all financial institutions that can engage in financial abuse and not just offshore banks. Let us learn from our past mistakes on creating new unfunded mandates.

Finally, I would appreciate knowing the reasons behind footnote 1, under item 3, on “Discussion of Strengthening Financial Sector Work and Surveillance,” which states that the ministers should mainly focus on this item in their interventions.

On item 5, under other issues, EVO stands out like a sore thumb. As it is not on a par with other agenda topics, I would suggest removing it.

Mr. Yoshimura made the following statement:

It is my belief that the agenda of the IMFC ministerial meeting needs to be well focused and provide ministers with an opportunity for meaningful discussion. In this context, I appreciate the proposed draft provisional agenda for its selectivity. However, I also believe the agenda needs to respond to the interests of ministers. On this point, I have a few comments.

> First, on item 3, "The IMF in the Process of Change," there is a footnote saying that the discussion of this item will focus mainly on the topic "Strengthening Financial Sector Work in the Surveillance." Like Mr. Shaalan, I have a question on this footnote. Since this item includes the conditionality review in addition to financial sector issues, which has a fundamental implication for the activities of the Fund and is an issue ministers are interested in, it is not clear to me how we could avoid the conditionality review becoming the focus of the ministerial discussion.
>
> Second, ministers are also highly interested in how to ensure the appropriateness of country representation in the Fund, including a review of quotas, as this is a precondition for the Fund to make globalization work for all. I therefore propose that this issue be included in item 5, under "Other Issues."
>
> In addition, the working group in the Fund and Bank on the review of the selection process of the Managing Director of the Fund and the President of the World Bank, are close to finalizing their joint report. I hope this issue can be included under item 5.
>
> Finally, on the issue of the joint meeting, I can go along with the consensus. However, in the spirit of streamlining the agenda, I support removing item 4, "Fighting Poverty and Strengthening Growth," from the IMFC agenda so that it can be discussed solely in the joint meeting, to avoid duplication of discussion.

The Secretary suggested that the reference in footnote 1 could be deleted.

The Chairman agreed, and said that conditionality was a major item, and that it was his interest that that issue was discussed carefully.

Mr. Mirakhor said that the Chairman had always suggested that there needed to be clear lines of demarcation between the responsibilities of various organs of the Fund, and that the IMFC was an advisory committee. Therefore, the Board should be careful in putting items before the IMFC that had not yet reached consensus in the Board. He agreed with Mr. Shaalan that when reporting on the progress of an issue, it was important to state what had been happening in the Board and what stage the Board had arrived at, and to allow the IMFC to respond to those issues. On other issues, especially surveillance and combating financial abuse, he supported Mr. Shaalan's suggestion that the Board had to be careful and note that that issue was outside the Fund's expertise. If it was to be addressed, then those who would want the Fund to become involved needed to explain where the resources would come from. If that issue became part of surveillance, it had to take into account the issue of symmetry of surveillance for the entire membership.

The Chairman said that the Board could not preempt what ministers had to say and that financial abuse was an important theme. He agreed with the view that the Board needed to be careful when placing new tasks on the institution, which needed to know where the resources would come from. He said that Mr. Mirakhor need not be concerned about that issue, as he would ensure that the Board would know where the resources for any new task would come from, if the mandate for that task was defined and accepted by consensus at the Board.

Mr. Milleron made the following statement:

> Overall, a good agenda: It draws an appropriate balance between the immediate challenges facing the finance ministers in the course of the current world economy slowdown, and the medium-term issues facing the Fund in the globalization process.
>
> Looking in more detail at each heading and subheading:
>
> On surveillance issues, I would indeed expect quite a lengthy discussion there since, without precluding our forthcoming discussion on the WEO, the current uncertainties in the world economy may deserve proper exchange of views between the governors on potential world vulnerabilities and downside risks.
>
> Under the "IMF in the Process of Change" heading, which encompasses the second substantive part of the ministers' discussions, allow me the three following remarks:
>
> First, I must confess that I am a little disappointed that the report by the Managing Director to the IMFC, concerning the IMF in the Process of Change, is scheduled on the Board agenda only on April 20. Of course, I understand that the bunching period during that week, especially with an IMFC Deputies' meeting held in the same period, adds to the timing constraints, but I hope that scheduling the Board in the late days of the run-up to the Spring Meetings will not prevent us from giving full justice to the report of the Managing Director.
>
> Second, I see a lot of merit in the expectation that ministers will focus their attention on the financial sector work and surveillance issues; my guess is that sufficient time should indeed be devoted to issues such as the fight against financial abuse and money laundering.
>
> Third, I would see a lot of grounds in devoting sufficient time to the Streamlining Conditionality issue, which may deserve substantive exchange of views among ministers.
>
> In addition, I would expect a status report on Involving the Private Sector in Crisis Prevention and Resolution. It may be felt that progress has been scarce since Prague, but I would feel that such an argument cuts both

ways: It's precisely because more work needs to be done to ensure a consistent and coherent implementation of the agreed PSI framework that the ministers should have a look at the issue and at the remaining challenges.

On Fighting Poverty and Strengthening Growth:

I agree that such a discussion should take place at a joint meeting of the IMFC and the Development Committee, for two reasons.

First, there is an evident overlap between the Fund and the Bank on issues such as Enhancing the PRGF and the PRSP Process and Following Up on the HIPC Initiative.

Second, there is a positive signaling effect on the effectiveness of the collaboration between the Fund and the Bank, coupled with the fact that shareholders consider that the IMF and the Bank play important complementary roles in that area.

Mr. Barro Chambrier made the following statement:

It would be wise to try to limit the number of topics in order to be effective. The difficulty is for us to reach a consensus on those topics that should be removed from the agenda. Let me say that with regard to keeping the world economy on course, it would be interesting to consider the policy recommendations from an IMFC point of view. It would make sense, because we are presenting a situation with risks and vulnerabilities, but our policy recommendations are missing.

On item 3, the discussion on streamlining conditionality is important, but we have also to take into account that we still have some progress to make, and the issue of strengthening ownership was not covered in our discussions. I believe that this issue will require further Board consideration, so I wonder whether we should keep the second part of the title, even if for us this is an important issue that will require strengthening capacity building.

I am among those who are in favor of a joint meeting of the IMFC and the Development Committee. It makes sense to see the progress in light of the last meeting. It will be important to prepare this meeting carefully, so as to be efficient. Two points are missing. There is the challenge of maintaining long-term external debt sustainability. We need to make that more explicit in the bullet points.

For example, the issue of following up on the HIPC Initiative could be replaced by the challenge of maintaining long-term external debt. I also believe that the main issue is progress in securing financing for the HIPC and the PRGF, which I do not see mentioned. We are at a stage where we need to see how the operationalization of the initiative is taking place, and therefore it would make sense to have this point on the agenda.

On the postconflict countries, this is an important issue for us, but as Mr. Shaalan was rightly emphasizing, it would be good to see if there is some good news with regard to the financing, because this is a key question for our framework that is not providing results because of lack of resources. It would be better if some financing was forthcoming.

Mr. Portugal made the following statement:

Every time we discuss the agenda of the IMFC, I start by repeating Mr. Shaalan's suggestion to reduce the number of items under discussion. We have three major items, but there are many bullet points under these major items, each one of them being a major item. Perhaps we should consider whether we should keep issues, where there is nothing new, on the agenda. I agree with Mr. Shaalan on the question of involving the private sector in crisis prevention. The issue of standards is now in implementation mode, and I do not know if there is anything new that we should still discuss.

The first item, as many others have said, should probably be one of the main topics for discussion. I agree with Mr. Barro Chambrier that, in addition to looking at the global outlook and the risks, it would be important to see what are the policy recommendations that we derive from that initiative. I agree with the topics mentioned in bullet item 3. Perhaps there is no need to discuss private sector and standards and codes, but all the other topics are important. The distinction between a progress report and what is going to be discussed has disappeared, and therefore we can take out the subtitles from the final agenda.

On the question of the joint meeting, I have to confess that I have some personal sense of guilt on this issue, because the first time the joint meeting was discussed in the World Bank, it was almost defeated and I was in favor of having a joint meeting because it seemed rational having the same topic, HIPC at the time, discussed in a joint meeting. But I was naive and not paying attention to the importance of precedents and repetition in this organization. Once we start something, it is difficult to eliminate it. Usually, we hold the joint meeting only at the Annual Meetings, but now we are having it during the Spring Meetings. I will go with the majority, but I am less convinced about the effectiveness of a meeting for 48 people, except for the press coverage and the photo opportunity. I am not convinced that this is an effective way of dealing with subjects. I agree with those who said that if we have a joint meeting, then these items should disappear from the agenda of the IMFC.

> One of the items which has been included under item 4, which is "Improving Market Access for Developing Country Exports," is of a more general nature and not related only to the poorest and HIPC countries, and I wonder whether it could be placed under the other items as item 3.

Mr. Lehmussaari made the following statement:

> First, on WEO, like other speakers, I find that this is a particularly important topic. We should do our best to preserve enough time for that discussion. In this context, I wonder whether there are some ideas of what will be discussed during the lunch.
>
> As regards the item 4, there is a third bullet, "Improving Market Access for Developing Country Exports." As far as I know, there has been no discussion of this topic in the Board and there is no paper available. While this is an important trade policy issue, I wonder what the Managing Director is going to report on if there is no Board discussion. It is important that all the matters included in the agenda should have been discussed in the Board, and I have not been able to find anything about the trade policy.
>
> As regards the joint meeting with the World Bank, I belong to the minority, but I am not in favor of this idea and Mr. Portugal has already hinted toward that direction. It is practically difficult to arrange any meaningful meeting for the 48 ministers to talk on any substantive matter, and what happens often is that a few ministers take the floor and the meeting is over. And those few ministers often come from major industrialized countries. The rest of the ministers are not important enough to express their views. That is one reason why I do not see a reason for these meetings to take place every time we have a Spring or Annual Meeting. Also, the Development Committee is a joint committee. The symbolic touch is not important. If we are losing in substance, we are losing in time. I would leave that symbolism to other occasions and try to hold these joint meetings only when something exceptional is happening.

Mr. Shaalan agreed with Mr. Lehmussaari that the Board should not put a topic on the IMFC agenda unless it had been discussed by the Board; however, market access was going to be discussed in the World Economic Outlook, which was sufficient to include under item 3. He supported Mr. Portugal in that regard, particularly as that issue went beyond fighting poverty.

Mr. Donecker made the following statement:

> I would like to associate myself with the remarks made by Mr. Milleron on the agenda. We have to strike, as always, a balance between reporting progress to the ministers and at the same time respecting the role of the IMFC in advising the Board on its future work. We can bring new items to the attention of ministers which we feel are worth discussing, and at the same

time we have to provide room for the ministers to discuss those topics which they feel are important. One item is private sector involvement. We have made some progress in this area over the last months, and ministers will want to talk about that issue.

I can go along with the idea of a joint meeting, but as an ad-hoc event and not in order to institutionalize this meeting. I agree with Mr. Shaalan and Mr. Portugal that it should not be on the agenda of the IMFC, but should have a separate agenda.

Mr. Wijnholds made the following statement:

My authorities do not see a need for a separate joint session for the reasons already put forward by Mr. Lehmussaari and Mr. Portugal. While I do not have strong feelings about this, we do not see any major items in the area of poverty where real guidance is needed. However, I will go along with the majority.

I am glad that footnote 1 is off the table. I feel it is important for ministers to discuss streamlining conditionality, and they will want to give guidance in this area. I was glad to see that for the Deputies, agenda conditionality is the first item.

I was also curious, as was Mr. Lehmussaari, to know what topics will be discussed for lunch, perhaps financial abuse or money laundering.

As regards the item "Improving Market Access for Developing Country Exports," it is important, and I have no problem with covering that separately. However, you are right, Mr. Chairman, that trade is an important element in the response to the slowdown in the world economy. In that context, if there are strong feelings to have it separately under item 4, that is acceptable to us.

Mr. Kiekens made the following statement:

The follow-up of the WEO discussion is an extensive report by the Managing Director in which a summary is given of the outlook, the policy responses, and a questionnaire for the members of the IMFC, asking them to react to the various points. You have the full option to make a clear suggestion at the outcome of the WEO discussion for the policy responses that the Board and management suggests to be discussed. Therefore, based on the discussion in the Board on the World Economic Outlook, I encourage you to make a report in line with that discussion. And if there are divergent views, you can mention them, and you can take positions.

I can live with the proposed agenda, which is a good basis. I would suggest in agenda point 3 to have topics for discussion first, and then to include conditionality, financial markets focus, and combating financial abuse. There are three topics for discussion under the heading "IMF in the Process of Change," followed by the progress report by the Managing Director. This suggest that there should not be an extensive discussion on PSI and on implementing standards and codes.

The Chairman said that seemed reasonable.

Mr. Kelkar made the following statement:

Like my other colleagues, I also feel the world economy discussion is the most important part of the forthcoming meeting, and to facilitate the more intensive and interesting discussion, I also agree with those who do not believe we require a joint Fund-Bank meeting, because the last time it took up many resources and the Committee's time. We should not continue that experiment again, and I suggest that we do not have a joint meeting, because it takes up too much time. I agree with Mr. Barro Chambrier that we should discuss policy recommendations.

Regarding the point made by Mr. Portugal, I share his view that under item 3, we could reduce some of the bullet points to make it more manageable, but I leave that up to the Managing Director.

The last point I want to make--perhaps I am a conservative man, but while I see the logic of having themes for our meetings, the present title suggests an overreaching of our ambitions.

The Secretary explained that on this occasion the agenda had an overarching theme—"Making Globalization Work for All." Another difference was that item 2 was not called "The World Economic Outlook," but rather "Keeping the World Economy on Course," to provide a better sense of the actual theme.

Mr. Mirakhor said that item 4, "Fighting Poverty and Strengthening Growth," would be considered by the Joint Committee. That would require raising public consciousness and attracting support from the public, and would raise the profile of that issue. He believed that it was important for the Fund, at this juncture, to ensure that all vehicles available to raise public consciousness, to raise the profile of that issue, and to try to elicit public support should be used.

Mr. Oyarzábal made the following statement:

First, I would like to identify myself with the suggestion made by Mr. Kiekens. It goes in the right direction. Also, the issue of market access should be on the agenda and could be included in the area of policy recommendation, but could also be included in issues relating to the PRGF and HIPC Initiative because it is central to that effort. With respect to the joint meeting, although I am not in favor, I am open on that issue.

Mr. Chelsky made the following statement:

With respect to the point that Mr. Kiekens made, I was going to make a similar one. What we used to do on agendas for IMFC is to have a section with reports that were tabled for the information of governors, rather than for the discussion. This ensured that the issues were mentioned on the agenda and that the reports were prepared, but governors were not expected to discuss them, even though they could if they wanted to. I understand Mr. Kiekens's suggestion to be along those lines. For example, standards and codes, where we are in the implementing stage, could be relegated to that section.

We support a joint meeting for a number of reasons, including the one mentioned by Mr. Mirakhor. That being said, I acknowledge that these meetings are not the most effective vehicle for having discussions, and Mr. Lehmussaari's points are well taken. Perhaps we could look at ways of facilitating a more broad-based discussion, or at least more broad-based in terms of who takes the floor during the discussion.

It is also worth considering that if we are going to have a joint session and take section 4 off the agenda, the IMFC is not going to have a substantive discussion of these items, and therefore we may want to retain "Market Access for Developing Country Exports" on the IMFC agenda.

With respect to the lunch, we should ask what can best benefit from the informality of the lunch format. It lends itself to more long-term issues where ministers would feel comfortable, without having officials standing behind them. Given the extent to which you, the Managing Director, has germinated the longer-term issue of trade liberalization, I suggest that there may be some value in asking ministers to discuss what role finance ministers have in pressing ahead on the trade liberalization agenda. Part of the problem in a more open discussion of trade liberalization in an IMF context is that these are not the ministers who have the lead role on that agenda. But, clearly, they have an interest in it. And when they say things in public fora, they are constrained by the fact that it is not their responsibility. Having them in an informal setting, you may be able to receive insights and guidance with respect to how the Fund can push forward that agenda and how they can help. I do not know if you would be able to get that in a more formal context.

On some of the specifics, with respect to the postconflict issue, I note that we are having the discussion of postconflict assistance on April 11, which is a week and a half from now. The paper is not yet out, but I hope that it is coming soon. The reason I raise the issue is that the existing postconflict policy we have has a nuanced but important distinction between the role of the

> Bank and the Fund in postconflict countries. And we run the risk of having that distinction blurred. In effect, the Fund's major role in postconflict countries has been catalytic through the provision of technical assistance. It has not been a financing role. We have argued that the financing role is a minor role, and expanding that is not necessarily appropriate, and unless the Board has adequate time to lay the groundwork for that discussion and make the distinction clear between what the Fund's role is and what the Bank's role is, we run the risk of blurring that distinction and having bilateral donors off-loading financing responsibilities onto the Fund. I am aware of the comments made by Mr. Barro Chambrier on the importance of financing, but there is a bilateral responsibility that is easily off-loaded onto the Fund when we talk about postconflict issues. We need to be careful about the timing and the groundwork for that topic. Having that discussion in the joint session concerns me somewhat, from that perspective.
>
> Given the fact that the revised version of the Review of Governance paper has come out, I wonder whether there is some benefit to reflecting this on the agenda, perhaps as one of the reports to be tabled. It would provide a useful counterbalance to the streamlining of conditionality and the strengthening of ownership, particularly from the perspective of those who worry that streamlining conditionality is weakening conditionality.
>
> Lastly, on conditionality, I side with those who emphasize that this is a progress report, and we should guard against these meetings being used to try to reach premature conclusions. Perhaps we want to use this opportunity to more clearly articulate what the path ahead is in terms of the discussions to come.

Mr. Barro Chambrier said that the issue of postconflict countries was critical for his chair. During the Managing Director's meeting with heads of state, there had been some request for the subsidization of resources that were provided in the framework of postconflict. The main issue was how to solve the question of the resources available, the question of the preferred creditor status, as some sister institutions would like to be paid at the same time as when the situation was clear at the Fund. Also, there was also the problem of having a more comprehensive program with regard to the negotiations with the Paris Club. If a framework could be provided that showed the delineation of responsibility that could help to solve the problem, then a discussion would be welcome. If the progress report would say that the Fund had not made further progress on that issue, as in the past, then that would not be helpful, especially at a time when the Fund wanted to mobilize resources for those countries.

Mr. Guinigundo made the following statement:

> We share the views held by other Directors in saying that all the topics on the agenda are important--particularly the world economic situation. And we agree to include the element of policy recommendations in the discussion

on the situation of the world economy, as well as in the discussion on market access.

At the same time, we cannot disagree on those topics, which would have a far-reaching impact. However, my concern is administrative. Do we have enough time to squeeze all these issues into one day? What do we envision in terms of developing these topics to ensure that we are advancing several steps from last year?

We therefore support the reduction in the number of topics to those in which the Fund has core competency; other topics which cannot be discussed at length can be presented as progress reports, and EVO can be discussed somewhere and sometime later.

Which brings me to the possible joint meeting between the IMFC and the Development Committee to discuss the issue of poverty and strengthening growth. The substance of the issue appears to me to be better discussed in the Development Committee, which is a joint meeting. However, in as much as the Fund itself has been involved in such development issues in both its adjustment programs and public pronouncements, and it is going to be a consensus here, we would not object to a joint meeting between the Development Committee and the IMFC.

Mr. Zoccali made the following statement:

In general, I belong to the camp that favors brevity and focus in terms of the number of issues that ministers are asked to address. In this regard, I favor the proposal that was advanced by Mr. Kiekens in the sense of limiting the discussion topics under item 3 to issues on which ministerial guidance might be useful and on which there is a basis for moving forward. Without doubt, the main point of relevance for this meeting is the World Economic Outlook. Here, as other speakers, we would prioritize this issue, the policy recommendations that we would put forth, and the question of trade. The trading environment offers an important prospect for orderly restoration of growth prospects in the world. On this issue, we would favor an in-depth discussion.

On the question of the joint meeting, we would go with the consensus. But unless support has been sufficiently mobilized on the individual aspects that have been included, we are not going to go beyond a mere photo opportunity.

I am attracted to the suggestion that was put forth by Mr. Chelsky for the lunch. The issue of trade liberalization, even though finance ministers are not necessarily those entrusted with the main responsibility, could give way to a lively debate, as in part their responsibility touches on the issue of producer prices, on the question of the tariff structure, and on the question of export competitiveness. An informal meeting of this sort might serve to usefully advance the debate.

Mr. Schlitzer made the following statement:

> The provisional agenda is comprehensive and strikes a good balance among the different topics and important items. Conditionality and money laundering are given the place that they deserve.
>
> On item 3, I would agree with the suggestion made by Mr. Kiekens that seems to me an improvement, on conditionality in particular. This is not just a stock-taking exercise. Ministers would like to give some guidance.
>
> On the joint committee, at this time it is useful to have a joint committee meeting that would discuss topics related to debt. We would go along with the alternative, which is to take item 4 off the IMFC agenda. How we can go beyond debt relief and improve market access for developing countries is something that we have to explore.

Mr. Donecker suggested that it would be more appropriate for finance ministers to talk about strengthening the Fund, focusing on financial markets and crisis prevention, during lunch. However, he agreed with Mr. Schlitzer that "Improving Market Access" was placed well under "Fighting Poverty and Strengthening Growth," as it was part of that strategy.

The Chairman said that he wanted to talk about cases of possible crisis during lunch. In that context, PSI could also come up. While trade liberalization was important, there were constraints in timing, and that topic was not a core issue for finance ministers. He suggested that that had to be an element of the WEO discussion. He added that his report on fighting poverty and strengthening growth was going to be a joint report by President Wolfensohn of the Bank and himself, and would include a section on market access for developing countries. While he had a lot of sympathy for Mr. Chelsky's idea, because of the time constraints, that topic was not appropriate for the luncheon. However, an advantage of the luncheon would be the opportunity to talk without formalities about possible worst-case scenarios of a crisis. The combination of crisis cases and PSI would make up the luncheon discussion.

Mr. Lushin made the following statement:

> On item 3, I agree with the remarks made by Mr. Kiekens, that we should concentrate on three issues—that is, conditionality, financial markets, and combating financial abuse.
>
> With regard to the joint meeting, our previous experience suggests that it is not the most effective means to discuss real problems, and the major importance of the joint meeting is public relations. However, the PR aspect of the HIPC is more than well presented already, and I therefore have some

doubts about the necessity of the joint meeting. But if there is a majority in favor, we would be prepared to go along.

On market access, we believe this issue is not well placed under item 4, because this goes beyond the issues of poverty and debt relief. It would be better placed under item 2 dealing with the global economic situation.

On postconflict countries, I associate myself with the remarks made by Mr. Chelsky that we would need to have a clear understanding of what we are going to propose, and what resources could be available to go ahead with some new constructive ideas. So far, it is difficult to say what will be the main focus of discussion. Finally, postconflict countries may also be treated as a broader issue beyond just poverty and debt relief, because some postconflict countries are not under the HIPC Initiative.

Mr. Al-Turki made the following statement:

Let me first express my support of the views of Mr. Shaalan that we should try to limit the number of items included in the agenda for the next meeting and for future meetings. Hopefully, we will be able to make some progress in this regard. But, more importantly, any items included in the agenda should be discussed by the Board before we include it in the agenda. Having said that, I could support including policy recommendations and improving market access for developing countries under item 2.

With regard to item 3, I fully support Mr. Kiekens.

On item 4, we agree with Mr. Barro Chambrier that we should modify the wording of the second bullet following up on the HIPC Initiative to include external debt sustainability.

With regard to item 5 and the proposal to include the quota formula review, the Board has not discussed this issue, and we should discuss it in the Board before we include it in the agenda.

With regard to item 7 under press communiqué, I hope that the communication between the Chairman and the governors will include a proposal by the Secretary to improve the preparation of the communiqué so that the unintentional mistake that happened last time will not be repeated.

Mr. Zurbrügg made the following statement:

I have four brief points. I support Mr. Kiekens on the restructuring of point 3. On the joint meeting, my authorities are in favor of maintaining the meeting; all the comments made on its efficiency are well taken. My authorities feel it would send the wrong signal, after having received joint letters from you and Mr. Wolfensohn, if we abolish that meeting at present.

The third point is on other issues, EVO. Since this chair is chairing the Evaluation Group, it would be unfortunate if we delete this point because the group is confident that we will have a nominee for the Director position, and it would be the appropriate moment to communicate this to ministers.

Also, you have solved a problem of mine concerning the lunch. My authorities had asked me to try to introduce a point where we could take up a specific case. I had argued that this is not usually done in the IMFC framework, and therefore taking up your suggestion would be perfect.

Mr. Yoshimura said that concerning the issue of EVO, the last IMFC communiqué had mentioned the EVO selection process. Some progress had been noted, and further progress was expected by the IMFC. Therefore, there was an obligation to report to the IMFC on that issue if the Fund was close to reaching a selection of Director.

In the same vein, the review of the selection process of the Managing Director and the World Bank president was an issue that was also included in the last IMFC communiqué, which had mentioned that the Fund working group should report, together with the Bank, on any progress. The Bank mentioned that they would report to governors in the spring of 2001; therefore, indirectly, the IMFC was also expecting a report from the Board on developments.

Mr. Donecker agreed with Mr. Yoshimura on the latter point, and suggested having an interim report if not enough progress in both sides had been achieved.

Mr. Wei made the following statement:

On the joint conference, I am supportive of this meeting at this juncture, due to the importance of this topic and the work the two institutions have conducted in the past several months. However, I agree with Mr. Donecker that it should not be institutionalized, but held on an ad hoc basis. Secondly, on the trade issue, I share the views expressed by Mr. Shaalan and others. This is important, but I am flexible as to whether to keep it under item 4 or move it to other items.

On item 3, I also support Mr. Kiekens's proposal. And I also support Mr. Yoshimura's proposal regarding the representation of member countries in this institution, but I am looking at it from the point of view that developing countries are underrepresented in this institution. On the lunch topic, I have no definitive view; however, if you take the representation issue, I believe the discussion will be lively.

Ms. Lundsager made the following statement:

This agenda covers many of the issues we have been working on, and we are comfortable with it. In terms of some of the subjects, a lot seems to come together in the Fund's role in crisis prevention and resolution. We have taken many of the different topics with a focus on how we can make the international system work better, and how we can help countries be better prepared. That was the overarching theme that jumped out at me when I looked at the different topics. Important in that area is the strengthened surveillance, the closer attention to financial sector work, examining vulnerability indicators, looking at implementation of standards and codes, and combating financial abuse and money laundering. Mr. Kiekens made a sensible suggestion as to how that could be organized, and will help focus discussion, but we should have other topics available as reports for ministers to discuss if needed. That is a sensible way of trying to organize our approach.

On conditionality, all Directors have said that it will be an important discussion since there are still many different issues which we have to sort out in terms of how we go forward. It will be useful to hear ministers' views on that. Like Mr. Milleron, we noticed that this will be covered in the draft report to the IMFC on the IMF in the Process of Change, and we, too, hope that we have enough time to review that thoroughly and discuss it and make sure that we are all comfortable with what is in that report when it is sent to the IMFC.

The poverty reduction issue will remain with the Fund for a long time as one of its most important matters, and we are comfortable in having a joint session of the IMFC and the Development Committee. I take the comments some Directors have made, but we should make it incumbent upon ourselves to have an effective meeting and ensure that the whole purpose we are trying to achieve is to have the institutions work well together.

Regarding the matter of trade, the agenda item "Improving Market Access for Developing Country Exports" is broader than that. There is also the issue of trade among developing countries, and the issue of structural adjustment, so as to take advantage of trade opportunities. I would feel more comfortable if it was a somewhat broader topic in terms of trade and development. In that regard, in terms of putting trade formally on the agenda for the global outlook of the world economy, having our finance ministers spend a lot of time talking about that as a separate item is not the most effective use of their time. Basically, we risk having an outcome that trade is good, and everyone should liberalize, whereas we should focus on the guidance we need from ministers to help us carry out our work.

Mr. Collins made the following statement:

> On the joint meeting, we are in favor of that, and of taking all the bullet points in item 4 and moving them into the joint meeting. For the reasons you gave, that has to include the market access item. Also, trade and market access will inevitably figure under the World Economic Outlook as well.
>
> On item 3, Mr. Kiekens's simplification probably would work.
>
> On the EVO and the appointment of the Managing Director, Mr. Yoshimura is right. We owe ministers a response to their request to the Board to work on those items made in the last communiqué.
>
> On the titles, I am also somewhat skeptical about both the changes. "Making Globalization Work for All"—you could play around with that and make it "All Work for Globalization." And as for "Keeping the World Economy on Course," it is not clear if we want to keep it on that particular course at the moment. It might be worth thinking about what that really means.
>
> Finally, on the lunch, I do not know to what extent the Chairman has a role in this agenda, but he has to be comfortable with an informal discussion which he is chairing with ministers. My personal view is that your suggestion is the best I have heard, because there is no doubt that uppermost in peoples' minds will be crisis cases, even if they are resolved by then. I will recommend to London that that would be the best topic for the luncheon.

Ms. Patel made the following statement:

> Very briefly, just to support the approach given by Mr. Kiekens on item 3. Also, with the exception of the item on combating financial abuse, I share Mr. Shaalan's views. I also agree with the joint meeting on item 4, and particularly with regard to the last point on the postconflict countries, we share the views expressed by Mr. Barro Chambrier.

The Chairman said that there was no need for the title "Making Globalization Work for All," as it created expectations. It had also been agreed that the global economy and the policy response was the number-one item and had to be discussed carefully. The issue of trade would be part of that discussion, because keeping up free and open trade was an element of confidence building and growth potential, and should be part of a structured response to the difficult global environment. The IMFC should express its commitment to trade and the opening of markets.

There was broad agreement to streamline item 3, as suggested by Mr. Kiekens and others, the Chairman continued. This meant that it would include the Managing Director's report, conditionality, strengthening ownership, and financial abuse. There had been a strong interest from shareholders to discuss those issues in-depth. Involving the private sector would be part of the Managing Director's report and would come up during the luncheon discussion. Implementing standards and codes would also be part of the Managing Director's report, and while ministers could make a reference to that issue, it should not be the focus of the priority-oriented agenda.

There was a majority for accepting a joint meeting on an ad hoc basis, but that should not be seen as a regularization of joint meetings, the Chairman stated. He was of the view that it was appropriate to have a joint meeting, because some effort had been made to demonstrate the new cooperation between the Fund and the Bank. It would make sense to take stock of what had been achieved.

Under "Other Issues," nothing spoke against not only reporting about having found the Director of EVO, but also including progress made with the review of the selection process of the Fund's Managing Director and the Bank's president, the Chairman added.

Mr. Wijnholds wondered whether the joint meeting would take time away from the IMFC agenda, and whether therefore it could be held on Monday.

The Chairman noted that not too many ministers would be able to attend the joint meeting the next day.

Mr. Donecker welcomed Mr. Wijnholds's proposal.

Mr. Barro Chambrier questioned the purpose of having a meeting when a number of ministers would have already left Washington. The Fund and Bank needed to be accountable and express to the outside world that they were taking those issues seriously. As Sunday would be the best day to have all the principle actors present, a way should be found to give room to that meeting.

Mr. Milleron said that it made sense to have a brief session, with short presentations on the advancement of the HIPC Initiative and the PRSP. It could also make sense to have one or two ministers from countries implementing good PRSPs to briefly present some comments. A meeting of no more than one hour's duration could take place on Sunday without any problems.

The Chairman said he was not in favor of holding permanent joint meetings. However, the PRSP process had a good chance to work if both institutions concentrated on their respective focus and worked together. It was important to take stock of the situation and to have confirmed by ministers that the PRSP process had been politically accepted. The Fund should be part of the process of monitoring how a reduction in poverty was being achieved. The PRSP process could be accepted as the vehicle for the coordination of the work of different institutions and fora. If ministers would join him in his assessment that the PRSP process was a good approach, and if they were committed to backing that process politically, then the joint meeting would have been successful.

The Secretary confirmed that he was paying attention to ensuring that the procedure for finalizing the IMFC communiqué was more foolproof than before, and that the mistake that had been made previously was not repeated.

On the issue of the timing, he had informally asked Mr. Esdar's office, Germany being the chair of the G-10 this year, to request the G-10 members to consider the possibility of beginning their meeting at 7:30 a.m. instead of 8:00 a.m., the Secretary continued. It was important to give enough time to the IMFC meeting.

There had been general agreement that item 4 would be taken up in the joint meeting, and would not be taken up separately in the IMFC or the Development Committee meetings, the Secretary stated. At the present time there was no consideration of holding the joint meeting on Monday.

The next step would be to reformulate the agenda as discussed, and to consult with the Chairman of the IMFC, the Secretary concluded.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/01/31 (3/28/01) and EBM/01/32 (3/30/01).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 98/27, 98/82, 98/87, 98/95, 00/2, and 00/79 are approved.

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/01/34, Correction 1 (3/28/01) is approved.

APPROVAL: October 12, 2001

SHAILENDRA J. ANJARIA
Secretary