

April 2, 2001
Approval: 4/9/01

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/57

10:00 a.m., June 7, 2000

Contents

Page

	Executive Board Attendance.....	1
1.	Honduras—Poverty Reduction and Growth Facility—Review, and Modification and Waiver of Performance Criteria; and Interim Poverty Reduction Strategy Paper and Joint Staff Assessment	3
2.	Morocco—2000 Article IV Consultation.....	46
3.	Cameroon—2000 Article IV Consultation; Poverty Reduction and Growth Facility—Third Annual Arrangement—Review, and Extension of Commitment Period; and Enhanced Initiative for Heavily Indebted Poor Countries— Preliminary Assessment of Eligibility	84
4.	Romania—Stand-By Arrangement—Review, Extension, Augmentation, Modification, and Waiver of Performance Criteria	126
 Decisions Taken Since Previous Board Meeting		
5.	Approval of Minutes	164
6.	Executive Board Travel.....	164

Executive Board Attendance

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

Executive Directors

S.M. Al-Turki
A. Barro Chambrier

A.G. Carstens
R.F. Cippà

K. Lissakers
J.-C. Milleron

A. Mirakhor

A.S. Shaalan

G.F. Taylor
Wei Benhua

J. de Beaufort Wijnholds

Alternate Executive Directors

A.S. Alosaimi
D. Ondo Mañe
P.R. Fenton, Temporary
M.J. Fernández, Temporary
W. Szczuka
R.J. Singh, Temporary
W. Merz, Temporary
D.H. Kranen, Temporary
P. Schollmeier, Temporary
J.A. Costa, Temporary
H. Vittas
C.A.E. Sdrilevich, Temporary
R. Djaafara, Temporary
S.K. Keshava, Temporary
J. Jonáš, Temporary
C. Josz, Temporary
I. Steinbuka, Temporary
L. Redifer, Temporary
G. Bauche
S. Le Gal, Temporary
I. Mateos y Lago, Temporary
M. Daïri
C. Rustomjee
J. Mafarikwa, Temporary
A. Lushin
S. Vtyurina, Temporary
S. Collins
R. Junguito
A. Maciá, Temporary
A.F. Al-Faris
K.I. Sakr, Temporary
W.C. Mañalac, Temporary
Tong Y., Temporary
Xu J., Temporary
Y.G. Yakusha
M. Yanase, Temporary

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary
J. Prust, Acting Secretary
Z. Ahmed, Assistant; R. Gudmundsson, Assistant;
G. Nkhata, Assistant; M. Schulte, Assistant; S. Soromenho-Ramos, Assistant

Honduras—Poverty Reduction and Growth Facility—Review, and Modification and Waiver of Performance Criteria; and Interim Poverty Reduction Strategy Paper and Joint Staff Assessment

Staff representatives: Sorsa, WHD; Seade, PDR

Morocco—2000 Article IV Consultation

Staff representatives: Nashashibi, MED; Ahmed, PDR

Cameroon—2000 Article IV Consultation; Poverty Reduction and Growth Facility—Third Annual Arrangement—Review, and Extension of Commitment Period; and Enhanced Initiative for Heavily Indebted Poor Countries—Preliminary Assessment of Eligibility

Staff representatives: Katz, AFR; Durand, MAE; Ahmed, PDR

Romania—Stand-By Arrangement—Review, Extension, Augmentation, Modification, and Waiver of Performance Criteria

Staff representatives: Zervoudakis, EU1; Brachet, PDR

Also Present

IBRD: I. Bannon and H. Lopez, Latin America and Caribbean Regional Office; B. Horton and E. Sinnott, Africa Regional Office; A. Vorkink, Europe and Central Asia Regional Office; P. Zacchia, Middle East and North Africa Regional Office. African Department: G.E. Gondwe, Director; E. Hernández-Catá, Associate Director; P.A. Acquah, Deputy Director; R. Abdoun, C.A. Francois, M. Katz, E.G. Kpodar, S.P. Leite, V.M. Moissinac-Massenat, W.A. Ossie, A. Tahari, I. Thiam. Asia and Pacific Department: S. N'guiamba. European I Department: M.C. Deppler, G.M. Bell, J. Fernandez-Ansola, T. Wang, E.J. Zervoudakis. External Relations Department: F. Baker-Meio, C.N. Lotze, L. Mboto Fouda. Fiscal Affairs Department: Y. Mustafa, A. Tazi. Legal Department: P. De Boeck, R. B. Leckow, I. Mouysset. Middle Eastern Department: P. Chabrier, Director; D. Burton, Deputy Director; P. Dhonte, Deputy Director; V. Fichera, E.H. Gardner, A. Jbili, H.M. Joly, M.M. Lazare, K. Nashashibi. Monetary and Exchange Affairs Department: K. Driessen, C. Durand, W.M.M. Fonteyne, L.I. Jacome-Hidalgo, P.L.C. Hilbers, M.B. O'Brien, C.M. Sampic. Policy Development and Review Department: M. Ahmed, Deputy Director; C. Brachet, W. Brown, D. Jones, A.F. Op de Beke, J. Seade, P. M.P. Mlachila, P. Tumbarello. Research Department: G.M. Milesi-Ferretti. Secretary's Department: S. Bhatia, P. Gotur, B.A. Sarr. Western Hemisphere Department: M.E. Bonangelino, Deputy Director; L.A. Cardemil, C.A. Paiva, P. Sorsa, M. Torres. Office of the Managing Director: A. Bauer, D.A. Citrin. Advisors to Executive Directors: J.M. Abbott, M.A. Ahmed, A. Del Cid-Bonilla, I. Dragulin, J.C. Estrella, O. Himani, A.R. Ismael, N. Jadhav, J.M. Jones, E. Jourcin, M.F. Melhem, J. Ntamatungiro, G. Schlitzer, M.R. Shojaeddini, S. Thiam, T. Turner-Huggins. Assistants to Executive Directors: E. Azoulay, S.A. Bakhache, S. Bonomo, J.G. Borpujari, R. Burgess, I.-K. Cho, G. De Blasio, T. Elkjaer, T. Hadded, K. Harada, M.S. Hililan, S. Hinata, I.C. Ioannou, B. Kelmanson, S.N. Kioa, E. Kornitch, K. Kpetigo, T.-M. Kudiwu, J. Nelmes, V. Rigász, A.A. Rojas, S. Rouai, J. Sigurgeirsson, T. Skurzewski, Sugeng, Vongthieres O., R.P. Watal, E.S. Weisman, A.Y.T. Wong, M. Yépez.

**1. HONDURAS—POVERTY REDUCTION AND GROWTH FACILITY—
REVIEW, AND MODIFICATION AND WAIVER OF PERFORMANCE
CRITERIA; AND INTERIM POVERTY REDUCTION STRATEGY PAPER
AND JOINT STAFF ASSESSMENT**

The Executive Directors considered a staff paper on the second review under the three-year arrangement for Honduras under the Poverty Reduction and Growth Facility, and Honduras' request for a waiver of performance criteria (EBS/00/77, 4/15/00; Cor. 1, 5/10/00; and Sup. 1, 6/5/00). They also had before them a staff assessment of the Interim Poverty Reduction Strategy Paper for Honduras, prepared jointly by staffs of the Fund and the International Development Association (EBD/00/32, 4/14/00).

Mr. Carstens and Mrs. Del-Cid Bonilla submitted the following statement:

We thank Fund management and staff for their continuous support and technical assistance during the time leading to the Executive Board review of Honduras Second Year Economic Program under the Poverty Reduction and Growth Facility. A constant and frank dialogue between our Honduran authorities and Fund's staff has been key in the elaboration of the Interim Poverty Reduction Strategy Paper.

At the outset, we would like to underscore the commitment of our authorities to continue during this year and the next with the stabilization and reform efforts, notwithstanding the coming electoral period. They are aware that it is indispensable for the country to persevere in applying a consistent policy framework, so as to create an environment that would lead to enhanced investment and additional growth capacity. It should be reassuring that in the post-Hurricane Mitch period, the Honduran government has upheld to a disciplined and consistent set of policy measures, fencing off huge pressures to apply expansive fiscal and monetary policies in a supposed attempt to mitigate (ephemerally) the huge basic needs among the population. The current Administration intends to work up to the last day of its period following the guidelines and commitments that are clearly stated in the memorandum of economic policies. The essence of the poverty reduction and growth strategy, which is portrayed in the interim paper, integrates in a consistent way two fundamental elements: (a) the continued commitment to a strong macroeconomic framework; and (b) other type of measures oriented to provide the bridge between the expected macro improvement and the well-being of the population at large.

The Government met satisfactorily four of the original five prior actions required for the completion of this second review. The actions met include the approval of an action plan to reform the Honduran Social Security Institute, which required a great deal of efforts on the part of our authorities. However it was not possible to achieve in time the approval of the Framework

Law on the Electricity Sector, although it was at the third and final debate in the National Congress, which went into recess for June.

Due to the deep-seated nature of the reforms formulated in the proposed legislation, the heated debate among all sectors of Honduran society has taken more time than anticipated. Nevertheless, our authorities believe that the slower process will lead to legislation reached through consensus, which will ensure a successful implementation of it. Approval of this law is expected no later than September 30 of this year, and our authorities are starting with the preparatory work toward privatization of electricity distribution to avoid further delays. The postponement of this prior action to the third review would allow the program to continue on track without being weakened in a fundamental sense, and at the same time make it feasible for Honduras to reach the HIPC decision point in the coming weeks.

Performance During the First Year Under the PRGF-Supported Program

During the first year of the program in 1999, our Honduran authorities continued implementing a strong stabilization and reform strategy oriented to support the reconstruction of the country following Hurricane Mitch, and to set the basis for sustainable economic growth and poverty reduction over the medium term. The outcome regarding economic growth, inflation, the external sector and the fiscal accounts for 1999 was better than envisaged under the program. With regard to the real sector, GDP declined 1.9 percent, much lower than the 3 percent originally estimated, whereas the inflation rate fell to 10.9 percent (the lowest since 1992), 2.1 percent lower than the rate targeted under the program. The central government fiscal deficit was contained at 4.1 percent of GDP and public savings reached 5.5 percent of GDP, when the program established levels of 7.6 and 5.2 percent of GDP, respectively. The strict fiscal and monetary discipline gave as a result a current account deficit lower than anticipated (5.8 percent of GDP compared to 9 percent), which contributed to the strengthening of the international reserves position, as it reached a level that allows to cover 4.3 months of imports. All the end-December of 1999 quantitative performance criteria were observed, except for base money which was exceeded by a small margin. This deviation was transitory, since it was related to Y2K issues.

Important progress was also achieved in the implementation of structural reforms. In the case of the financial system, supervision was strengthened and as of today on-site inspections of commercial banks have been completed for at least 75 percent of the system; legislation setting up a deposit insurance scheme and a regulatory framework for the stock exchange was submitted to Congress; and regulations governing activities of investment trusts were issued. Although with some delays, the privatization of the telecommunications company is now well underway, with completion

expected by mid-July. In addition, the bidding for the concession of airports was completed in March, the action plan to reform the Honduran Social Security Institute was recently approved by its Board, and the preparation of draft criteria for wage-setting in the central government was finalized.

The Program for Year 2000

The program for the year 2000, supported by the PRGF, has as main objectives to maintain macroeconomic stability and achieve faster economic growth, the latter through the intensification of the reconstruction process, the creation of larger incentives to attract private investment, and the promotion of exports. The government considers that these elements will be essential for attaining faster development and poverty reduction over the medium term. The main building blocks of the strategy are strong fiscal and monetary policies, coupled with continued efforts to pursue structural reforms, all in the context of the Poverty Reduction Strategy.

With regard to fiscal policy, the government is committed to sustain the efforts to strengthen tax revenue, to contain current nonsocial expenditures of the central government, and to improve the efficiency and targeting of social expenditures to better address the poverty reduction objectives. The government has defined a clear agenda in these three areas.

On the revenue side, our authorities will emphasize the application of measures leading to the improvement of tax administration, in particular with the goal to maintain central government current revenue over 18 percent of GDP. To this end, the Internal Revenue Office will: ensure a firm application of the penalties available under the 1997 tax code; expand the coverage of large taxpayers registered to establish better control and reduce tax evasion; increase access to third-party sources of information for cross-checking of purchases and tax returns; and review the structure of indirect taxes with a view toward reducing the number of tariff bands to minimize incentives for fiscal fraud. In addition, by end-June 2000 legislation will be submitted to Congress aimed at improving the income tax system by bringing it to international standards.

The government will also reinforce its efforts to contain nonsocial current expenditures. For this purpose, it will limit current transfers unrelated to social and poverty programs. In this line, last April the Ministry of Finance issued a decree to maintain austerity in current public expenditures. In addition, the central government wage bill, originally estimated to reach 11 percent by year 2002 due to legal commitments acquired in past years, will be contained to 9 percent this year, 9.3 percent in 2001 and reduced to 8.8 percent in 2002. To achieve these results, our authorities are committed to implement a reform of public employment and wage policy over the next two years. Within this context, it is expected that Congress will approve a new

civil service law by end-October, in order to introduce clear rules for annual wage increases, together with measures to rationalize employment and retrench redundant personnel. Meanwhile, our authorities will implement programs of early retirement, will cancel existing vacant posts and will eliminate specific treatments to some well-defined sectors.

To improve the efficiency and targeting of social expenditure, the government is conducting a comprehensive public expenditure review in collaboration with the World Bank, and continue with the outside monitoring of external assistance and regular audits of external inflow.

Social security and pension reform will be a key component of the social policy framework. A sound pension system will help reduce poverty, not only by offering pensions above the poverty line for the elderly, but also by stimulating long-term savings and investment that will lead to more and better paid jobs. The nature of social policy and its impact on poverty reduction will be evaluated in the process leading to the final Poverty Reduction Strategy Paper. Benefits and costs related to social policies will be fully assessed, in order to ensure their consistency with the macroeconomic framework.

By means of a sound monetary policy, the central bank aims at containing inflation to a range between 9 and 11 percent this year and for it to reach a single-digit level on a sustainable basis over the medium term. During the first months of the year, inflation has picked up slightly due to the increase in the price of oil and food. The Central Bank is monitoring this situation carefully and will act if necessary to comply with the annual target. The attainment of a falling inflation would bring important benefits in terms of a less volatile exchange rate, reduced uncertainties for business and investment decisions, and better income distribution. A lower inflation benefits, more than proportionally, the poor, since they usually do not have access to vehicles to hedge against raising prices. The fight against inflation will be pursued mainly through a tight control on the monetary base, which as time passes will be exerted more through market-based operations rather than by direct controls (such as mandatory investment requirements). This process, already underway, will not only enhance the effectiveness of monetary policy, but it will also help reduce one of the distortions that has kept real lending rates high.

Within the program of structural reforms, the government considers a main priority the strengthening of financial regulations and prudential supervision to ensure a healthy financial system that can effectively support macroeconomic stability and growth. On prudential regulation, the Banking Commission will complete its program of on-site inspections of all banks by end-June 2000 and will insist on all the necessary correcting measures in order to ensure sound banking practices and properly capitalized institutions. The

banks will be required to achieve a risk-weighted capital-asset ratio of at least 10 percent as of end-December 2000. The program of on-site inspections will be also extended to finance companies and savings and loans institutions. In addition, the strengthening of the supervisory entity (CNBS) will continue, through training of its inspectors and analysts.

To improve the efficiency of financial intermediation, our authorities will modernize the payments system. As a first step, they will accelerate the development of an electronic, fully integrated check-clearing system to make it operational in December 2000. Regulatory frameworks for insurance and reinsurance companies and for the stock exchange, and a limited deposit insurance system will also be approved this year.

With regard to the external sector, the current crawling band exchange rate system served Honduras well over the past years and, therefore, the authorities plan to continue with it in the near term. In order to improve export competitiveness, the government plans to eliminate the remaining export taxes and submit to congress a plan to restructure the coffee sector. In addition, they are committed to continue with a prudent debt management and abstain from contracting market loans. They are expecting to conclude the Paris Club negotiations on Mitch-related rescheduling in the coming months, whereas substantial debt relief was agreed last March with the Central American Bank for Economic Integration. Further trade liberalization will be pursued in the context of a free-trade agreement with Mexico and the Enhanced Caribbean Basin Initiative recently approved by the US Congress.

The social security and pension reform is considered by our authorities as essential to contribute to the development of the financial system as it will promote the availability of long-term funds, in addition to fostering economic growth by allowing more long-term private investment and limiting the growth of fiscal contingencies. The government initiated this reform by establishing a working group to settle pending claims between the government and the Honduran Social Security Institute (IHSS) last March. An action plan for separating the IHSS pension fund from the health fund and a plan for restructuring the institution were approved on May 24. Furthermore, a second working group with the task of analyzing options for a long-lasting pension reform will be created by end-June. It is the intention of the authorities to submit to Congress a draft law to regulate private pension funds by end-December 2000.

Our authorities are convinced that further privatizations, the deregulation and simplification of administrative procedures and the enhancing of good governance policies are fundamental for attracting private investment and achieving higher growth. The privatization of Hondutel should be concluded by Mid-July and, as was mentioned before, the Framework Law on the Electricity Sector should be approved in the next few months,

establishing the legal base to separate the generation, the transmission and distribution activities of the state monopoly, a transparent regulatory framework and extending authorization to the private sector to participate in electricity distribution. Moreover, our authorities, with support from the Inter-American Development Bank, will be working in a proposal to incorporate the private sector in the management, operation, and financing of ports. Finally, the framework law that would allow private concessions in the provision of water and sewage services should be approved by end-December 2000.

To improve governance, the authorities are preparing a comprehensive policy framework recognizing that, in a global environment, transparency of policies is critical to retain the trust of the country's external, financial, trading, and development partners. One of the main objectives of this policy will be to minimize potential corruption by reducing the discretionary powers of public officials. In this context, the government will review all regulations related to internal and external commerce and will seek to streamline and simplify the tax and subsidy systems. In regard to transparency of policies, our authorities will gradually comply with the codes for transparency in fiscal, monetary, and financial policies. Last but not least in the area of governance, the government is committed to modernize the country's legal system, by implementing a new penal and procedural codes in 2002.

Our authorities consider essential to strengthen economic and socio-demographic statistics in order to support policy-making in general and the poverty reduction strategy in particular. For this reason, they plan to establish a separate agency for Statistics and Census, and approve the relevant law that has already been sent to congress. They are also considering adhering to the IMF's General Data Dissemination System.

Interim Poverty Reduction Strategy Paper

Poverty reduction and the improvement of social sectors have been important objectives of Honduras' public policies for many years. However, although social indicators have markedly improved over the past several years, they are still among the weakest in Latin America. After the disaster caused by Hurricane Mitch, it is estimated that the percentage of poor households rose from 63.1 percent to 65.9 percent (from March 98 to March 99). In absolute terms the number of poor people increased by approximately 165,000. With the purpose of rebuilding and modernizing the country, the government prepared in 1999 a Master Plan for Reconstruction and Transformation, which was broadly consulted with civil society and the donor community. This plan includes, apart from a strategy for reconstruction, policies aimed at structural reforms and poverty reduction, and has been an important input for the preparation of the IPRSP.

Our authorities recognize the need for strengthening their current policies in order to reduce poverty on sustainable basis. In this context, their long-term poverty reduction strategy is based in the following principles: the maintenance and deepening of macroeconomic stability, along with prudent external debt management, larger private sector participation in the administration of public services and efficient public administration; the improvement of governance through increased participation of civil society, a strengthened justice system and decentralization of public services; the supporting of mechanisms for social audits, in order to promote efficient and transparent management of both public entities and nongovernmental organizations that develop programs and projects; the protection of natural resources and the environment, through a more efficient execution of the corresponding policies; and an efficient system to manage risk and deal with disasters, under a new legal and institutional framework.

Our authorities are developing this strategy with a broad and substantive consultation with civil society. They are committed to develop a full strategy by March 2001, in which they will clearly identify the links between the poverty diagnosis presented in the IPRSP and the strategy to be implemented, the targets to be monitored, the policies and actions to achieve these targets, the full costing of the proposed policies and programs and, their consistency with the macroeconomic framework.

In closing, we would like to reiterate our appreciation to staff and management for the support and encouragement provided to Honduras in the context of the Poverty Reduction and Growth Facility Arrangement.

Extending his remarks Mr. Carstens thanked Directors for their preliminary statements and noted that there appeared to be some concerns with regard to the capacity of the Honduran authorities to continue the reform process successfully during the upcoming election campaign. He assured Directors that there was an unquestionable commitment on the part of the Minister of Finance, the Governor of the Central Bank, and the President to adhere to the agreed strategy until the end of the tenure of the current administration, and to create an environment that encouraged continued support for that strategy after the election. At the occasion of the Managing Director's recent visit to Honduras, the President had given assurances of the authorities' intentions. The authorities had addressed that issue in a frank and constructive manner and were fully committed to ensuring that the country as a whole—and its individual institutions—continued the program, even if the elections were to bring a change in government. There was already considerable political momentum, which was likely to facilitate further progress in the reform process in the future.

While those developments were encouraging, it should be acknowledged that the current program was extremely demanding in terms of the expertise required to assess the new laws in the legislative process, Mr. Carstens continued. In view of that, congress should not be expected to pass the legislation at a fast pace and exactly in line with the proposed schedule—the complex issue of the framework for electricity privatization was a case in

point. While legislative activity had been intense, there were limits to the number of laws that could reasonably be passed within a given timeframe, particularly given the complexity of the issues involved.

At the occasion of the Managing Director's recent visit to Honduras, a high-ranking official of congress had expressed a similar view by pointing out that Congress was eager to ensure the ownership of the legislation passed, Mr. Carstens added. He had told the Managing Director that a thorough understanding by congress of all aspects of the legislative measures was a precondition for such ownership. Given that congress did not consist of experts on the electricity sector, and given that reaching a consensus on fundamental issues was important, there should be a preference for the quality of the legislative process and for strong ownership over the pace with which the laws were passed by Congress, and over strict adherence to a conditionality that was not owned by the country. Passing legislation on the privatization of the electricity and telecommunications sectors, and on social security was bound to be hampered by capacity constraints and bottlenecks within the political process owing to the complexity of the issues. Also, one had to bear in mind that legislation passed at a fast pace and without appropriate consideration and consensus building might produce negative effects for the implementation process.

Those considerations demonstrated that the request by the authorities for a postponement of the prior action relating to the Framework Law on the Electricity Sector was not a reflection of unwillingness or of a lack of public support for those measures, Mr. Carstens remarked. Rather, the request reflected the dynamics and the limitations of the political process in the country. It was important to take account of those capacity constraints, given that they were likely to play a role in similar legislative processes in the future.

With regard to the issue of the participation of civil society in the government's poverty reduction efforts, there had been proof of the involvement of numerous groups in that process during the recent visit of the Managing Director to Honduras, Mr. Carstens concluded. The authorities were planning to enhance further the communication process so as to satisfy international financial institutions and the donor community with regard to the effectiveness of policy making in Honduras.

Ms. Lissakers and Mr. Abbott submitted the following statement:

Our remarks will be divided into two parts. First, we would like to comment on the Interim Poverty Reduction Strategy Paper and then we will comment on the Second Review of the PRGF.

The Interim Poverty Reduction Strategy Paper divides rather neatly into two halves. The first half deals with diagnostic assessment of poverty, an analysis of social spending and trends in the development of human capital. The second half deals with the relation between poverty, growth, and the macroeconomic framework and it addresses the overall strategy for poverty reduction. Our remarks will concentrate on the second half of the paper since

that is where the issues of IMF competence are centered. Our views may reflect an institutional bias, but we thought the second half of the I-PRSP was better developed than the first half. The diagnostic assessment explains in detail the multiple dimensions of poverty in Honduras and it presents an inventory of the social programs now in place. It would be helpful if the next iteration of the PRSP could extend the diagnostic assessment to include an analysis of which social programs work best in reducing or alleviating poverty and which are less effective. Such an analysis could then provide the basis for a focused strategy that would guide social spending priorities in the future.

Wider consultation with civil society is likely to be helpful in shaping a strategy for social policy programs that best foster poverty reduction and poverty alleviation. We believe it will be important for the government to clarify 'the rules of the game' for its engagement with civil society. A key element of such rules will be establishing clear accountability within the government for ensuring that effective two way communication takes place.

To illustrate, we believe it will be important to collaborate with worker organizations to incorporate into the strategy sound labor-management practices that are rooted in respect for internationally recognized standards. For example, workers in privatized entities should be afforded full labor rights, including the opportunity to select union representation if they choose.

The second half of the I-PRSP shifts perspective. This section provides a clear analysis of the linkages between macroeconomic performance and poverty reduction in Honduras. This analysis is then used to support recommendations for the major components of a macroeconomic strategy that should contribute to both growth and poverty reduction.

A strong feature of the macroeconomic analysis is the close linkage between inflation and the incidence of poverty. During periods when inflation in Honduras has been contained or reduced, the incidence of poverty has declined, particularly among the vulnerable urban poor. Backsliding on inflation has been associated with a deterioration of the indicators of poverty. Clearly, inflation control should and does figure prominently as a major objective of the growth and poverty reduction strategy.

The macro analysis also points out that high growth has not led to as much poverty reduction in Honduras as it has in other low income countries. This is not for lack of saving and investment. Honduras has achieved savings rates significantly higher than the average in Latin America. The macro analysis points to the low productivity of investment as a systematic problem frustrating Honduras' ability to translate a strong saving effort into higher growth rates and in limiting the poverty reduction that should be associated with faster growth.

The macro analysis in the I-PRSP carries this line of thought forward to develop specific recommendations for a macro strategy. Public sector infrastructure investment is needed to support the productivity of private sector investment. The legal and administrative structure underlying private investment decision is both cumbersome and inadequate. Structural reforms in this area would enhance the productivity of investment. Public sector utility investment is particularly inefficient. Privatization is thus a high priority. The economy is relatively closed. Trade liberalization and a more open economy is recommended to encourage both an inflow of more productive investment and to encourage selection of more productive technologies by local investors. Financial intermediation costs are high, burdening the productivity of investment. Hence, the strategy emphasizes the continuing modernization of the financial system. Progressive labor legislation does not achieve the full benefits anticipated because of maladministration of the Honduran Social Security Institute. Hence, an emphasis in the strategy on completing planned reforms of Social Security.

Similar analytic underpinnings support other aspects of the proposed macroeconomic strategy. Based on the strategy outlined, the I-PRSP calls for raising Honduras' long-term growth objective to 6.0 percent rather than the implicit 5.0 percent target that has frequently been mentioned in recent Board papers. We agree that the articulated strategy justifies the more ambitious growth objectives.

There is still much work to be done to draw civil society more fully into the consultative process and to define a strategy for the more micro social programs that must be a basic component of the overall Poverty Reduction Strategy. The macro component of the strategy, however, is shaping up nicely.

If the authorities offer an attractive vision of their long-term macroeconomic strategy, the report in the Second Review of the PRGF gives a far less positive impression of their recent policy execution. Growth, inflation, the external accounts, and fiscal and monetary policy turned out o.k. in 1999. But these favorable outcomes were due more to happenstance rather than rigorous policy implementation. Reserves rose because overseas assistance could not be disbursed at rates anticipated. For a similar reason, public investment spending was held below budget limits and imports undershot program expectations.

Where strong policy discipline was required, the authorities' energy appears to have flagged. Planned and needed reforms of the social security system were postponed. Privatization plans have slipped. The central government wage bill has continued to swell despite expectations this well-documented problem would be contained. Lack of discipline on the central government wage bill is a matter of particular concern since this tends to favor the more privileged workers while leaving the vulnerable classes exposed to

the risk of future fiscal exhaustion. Reforms in each of the areas cited are a clear components of the authorities' medium-term strategy. Steady progress now would greatly strengthen the credibility of the medium-term strategy for poverty reduction and growth.

The staff write-up gives us some qualms about how much progress we can expect to see during 2000 in advancing the whole PRG strategy. It is true that privatization, social security and the wage bill are all on the policy agenda. However, the careful drafting in the staff report suggests that the policy goals for this election year are limited to best efforts rather than firm commitments. Elections do have a way of deflecting attention toward short-run political concerns. Nevertheless, we would encourage the authorities to implement vigorously the policy framework that has been established for this year so that, post election, a redoubled effort can be made to implement the medium term strategy clearly spelled out in the I-PRSP.

We can support the request for a waiver of the end-December criterion on base money and completion of the second review under the PRGF.

Extending his remarks, Mr. Abbott considered that the privatization process in Honduras raised a number of issues of general relevance to which the Board should pay attention. In view of the delay in the legislative process with regard to the Framework Law on the Electricity Sector, it was worth considering whether lessons could be learned from the experience that privatization programs often failed to gain sufficient public support owing to the lack of understanding by the general public that privatization had a direct positive effect on poverty reduction. Also, given that the Board discussion on the HIPC decision point for Honduras had come closer, it would be useful, at the current stage, for the Board to define its expectations with regard to the forthcoming staff report on that matter. Among other things, that report should provide evidence of the participation of civil society in the preparation of the program, information on the impact of interim relief, and a precise outline of how resources which were freed up by interim relief would be used. In that context, it would also be useful to explain the growth strategy in a more precise manner, in particular, the expected linkages between growth and poverty reduction, to list the steps necessary to finalize the PRSP, to establish a track record prior to the completion point, and to spell out the timeline for reaching that point. Also, his chair would like to see evidence that the proposed triggers for the completion point had been sufficiently explained to the public to ensure the appropriate participation of civil society in the process and to enlist public support for the entire program. The link between the I-PRSP, the country's strategy for external assistance, and the PRGF should also be made clear in that context.

Mr. Mirakhor wondered whether Mr. Abbott could clarify his statement with regard to the timeline between decision point and completion point concerning relief under the enhanced HIPC Initiative and asked whether Mr. Abbott had called for stretching out that timeline. Such a request would hardly be the appropriate signal to the authorities at the current stage, particularly in view of the fact that the Fund was already acquiring a reputation of being slow in implementing the enhanced HIPC Initiative.

Mr. Abbott responded that he had been asking for more clarity with regard to the steps to be taken between decision and completion point, and that those steps should be enumerated in the forthcoming documents. He was not calling for any stretching out of the timeline between decision and completion point.

The Acting Chairman noted that there was agreement between Mr. Abbott and Mr. Mirakhor on the matter in question.

Ms. Jul and Mr. Hendrick submitted the following statement:

At the outset, we would like to commend the Honduran authorities for their efforts to maintain macroeconomic stability and for the observance of most structural and quantitative performance criteria at end-1999. The strong signals of economic recovery and the downtrend in inflation as well as progress in the structural reform have set the basis for favorable economic prospects for 2000 and beyond. The authorities' strong commitment to sound macroeconomic management and reform has, so far, been unquestionable. In this regard, we welcome the decision to press forward with the privatization process, the reform of the social security system and the enhancing of good governance policies. As Mr. Carstens and Mrs. Del Cid-Bonilla explain in their comprehensive and informative preliminary statement, these are key issues to ensure medium-term viability of the fiscal and external accounts in a context of strong private investment and growth.

We also welcome the poverty reduction strategy paper presented by the Honduran authorities. The Fund and Bank staff have made a good assessment of the document. We agree that it meets the requirements for an Interim PRSP, provides the basis for a full-fledged PRSP, and represents an adequate framework for Fund and Bank concessional assistance programs. We look forward for the Board discussion to grant Honduras the decision point under the Enhanced HIPC initiative.

To accomplish the difficult task of reducing poverty, Honduras will not only need to maintain sound macroeconomic policies, but it will also need to increase domestic savings to support the high level of investment required to reach and sustain 5 to 6 percent of GDP growth during the next decades. Table 5 of the staff reports makes clear that to achieve this objective, the public sector will have to make an important contribution. In addition, the low productivity of labor and investment highlighted by the interim PRSP is also undermining potential for economic growth. The level of poverty and the pressing social agenda call for a faster speed of adjustment to regain higher economic growth and create new employment opportunities. Therefore, structural reforms designed to remove rigidities and improve productivity in the private and public sector will be key to sustain a non-inflationary path of economic growth.

Against this backdrop, and since we concur with the thrust of the staff appraisal, we will confine our remarks to three areas for emphasis: the financial sector, the fiscal sector, and structural reforms.

In principle, we concur with staff that a well-functioning financial system and the ensuing reduction of the prevalent high real interest rates is an important condition for the recovery of economic activity. In this regard, a more efficient monetary management with greater emphasis on indirect monetary instruments and the phasing out of mandatory investment requirement will facilitate a lowering of spreads and a reduction in real lending rates. However, to have a better understanding of the issues, we would appreciate some additional information from staff.

On the high lending interest rates, paragraph 16 of the staff report provides some qualitative explanations such as the risks associated to the uncertainties in the legal system, regulatory framework and inefficient banking practices. While progress is reported on the last two factors, we wonder what is being done regarding the legal system. The rule of law is a crucial condition not only for the efficient working of the financial system, but also for that of the economy at large.

On the use of indirect monetary instruments, staff indicates that the main tool to control the growth of base money will be an increased use of open market operations with Central Banks Certificates of Absorption (CAMs). In this regard, we would appreciate some further information regarding the use of these certificates as a key element of monetary policy and as to how they will relate to other instruments of monetary policy such as reserve requirements, rediscounts rates or intervention in the foreign exchange market. We also wonder if the program contemplates the elimination of mandatory investment requirements, and full reliance on open market operations, where the banks can freely bid the quantity and the price. Staff comments would be appreciated.

Regarding the authorities' decision to review options to restructure the central bank's balance sheet to increase the share of interest bearing assets, we were puzzled by the fact that at present a large share of central bank's assets bear no interest. Normally, one would expect international reserves to be invested on different assets bearing interest according to the maturity structure. Can Mr. Carstens or staff provide some additional insight on this issue?

Public sector reform is the cornerstone of the program. I welcome the authorities' decision to pass by end-October a new Civil Service Law, which will introduce clear rules for annual wage increases, rationalization of

employment, and retrenchment of redundant personnel. This is a key element to ensure medium-term fiscal viability.

We fully concur with staff's recommendations to contain current nonsocial expenditure of the central government and to continue with the efforts to strengthen tax administration. The medium-term macroeconomic framework in Table 5 of the staff report shows that despite all efforts, total central government revenue as a percentage of GDP will not experience any improvement during the next five years. At the same time, total expenditure as a percentage of GDP will observe a moderate decrease during the same period.

These numbers highlight the fact that there is no room for complacency. The authorities will have to be careful to avoid slippages in the program, particularly in controlling the growth of the wage bill, and pressing ahead with the social security reform and the privatization process. To better support the poverty reduction objectives, the government will not only have to generate enough savings but it will also have to improve the quality and efficiency of social expenditure.

Finally, since general elections will take place in 2001, it would be important to impress upon the authorities that it is key to maintain the momentum of macroeconomic and structural reforms in the run-up period to the elections and in the post election period. We welcome the assurances given in this regard by Mr. Carstens and Mrs. Del Cid-Bonilla in their preliminary statement.

With these remarks, this chair supports the proposed decision, including the request for waiver, and wish the Honduran authorities success in the process of adjustment and reform.

Mr. Bernes submitted the following statement:

At the outset, let me say that I support the second review of Honduras' PRGF and the authorities' request for a waiver of performance criteria. Honduras faces a long and difficult road ahead, given the need to continue the rebuilding process following the devastating impact of Hurricane Mitch, and a more fundamental need to reverse the negative growth in per capita income that was recorded over the past decade, while making significant advances in poverty reduction.

With respect to the PRGF, it is encouraging that most targets were met and policies are broadly on track. Nevertheless, as the staff points out, there are a number of areas where efforts need to be redoubled, and it is imperative that the authorities do not allow the upcoming electoral cycle to derail policies away from the longer-term development needs of the country. In particular,

the authorities cannot afford to lose control of fiscal policy, given the importance of increasing public savings to help finance development. In this context, I would strongly urge the authorities to follow staff's advice in implementing the available near-term measures to contain the public sector wage bill, while actively pursuing civil service reform to help put the public finances on a more sustainable medium-term footing.

The staff paper also rightly highlights the importance of faster growth and low inflation for reducing poverty, and the need to speed up progress with structural reforms aimed at removing the supply side constraints to growth. I would urge the authorities to move forward expeditiously in the areas of deregulation and privatization; in improving the quality of education and health services; and in further strengthening the financial sector. A more detailed plan to combat corruption and improve transparency is also needed. The authorities have listed governance issues among their key priorities, but progress has been slow. As the staff stresses, important progress will have to be made in reforming the justice and legal system, along with forward momentum on other elements of the authorities' strategy outlined in Box 5. Together, such actions will help to invigorate the investment climate, and boost the economy's productive potential.

In addition to achieving faster growth, however, it is also essential that the authorities implement policies for a high quality of growth, to achieve the maximum possible impact in reducing poverty in an equitable manner. This is important because, as noted in Box 3, economic growth does not pull as many people out of poverty in Honduras as it does on average in the rest of Latin America. It remains a challenge, therefore, to identify and implement policies that overcome this dynamic.

Indeed, this message is reinforced fairly clearly in the staff assessment of the authorities' interim PRSP. As work on the PRSP proceeds, therefore, a high priority has to be put on elaborating a long-term poverty reduction strategy, and in integrating the macroeconomic framework and key macroeconomic policies more closely within the authorities' poverty diagnosis and their poverty reduction strategy.

The staff outlines a number of such key policy areas in paragraph 10 of the PRSP assessment. I fully agree that these are fundamentally important.

One additional area of macroeconomic policy that should be elaborated in the context of the long-term poverty strategy relates to the monetary-policy framework. As it now stands in the context of the PRGF, it is unclear if there is a well-defined nominal anchor for monetary policy, or a well-articulated framework for the implementation of monetary policy. Monetary policy is described as supporting fiscal policy in achieving the program's inflation target, but at the same time it aims to manage the

exchange rate in the context of the program's crawling-band exchange-rate regime.

It is clear that the authorities are keenly aware that price stability is an important factor in laying the groundwork for poverty reduction. In this context, the macroeconomic framework embedded in the poverty reduction strategy should begin to consider clarifying the longer-term objectives of monetary policy, including the appropriate framework for achieving the objectives, the appropriate nominal anchor, and how the exchange-rate regime should evolve to provide a coherent and consistent overall monetary order.

As well, good experience has been gained from the authorities' Family Allowance Program in terms of addressing income inequality, and the lessons learned from this experience should be reflected in the PRSP. In particular, UN (and other independent) evaluations of the Family Allowance Program suggest that education is still inadequately funded at the primary level, while a disproportionate level of spending goes to middle and higher education levels.

Finally, Honduras just meets the minimum requirements of statistical reporting for effective supervision and monitoring. Good policies cannot be designed or implemented without reasonably good statistics, so it is encouraging that the authorities are moving forward in establishing a statistics institute and implementing STA recommendations. I encourage the authorities to push these tasks through to completion, and to participate in the GDDS as this will help provide a good frame of reference for statistical development.

Mrs. Mateos y Lago made the following statement:

On the PRGF, we are pleased to see that the program is broadly on track as far as its macroeconomic aspects are concerned. Nevertheless, as we already noted in our statement on the previous review, we are concerned that the good fiscal performance owes much to the fact that reconstruction efforts are badly lagging behind schedule. We understand that this might partly be explained by institutional capacity constraints, but we deeply regret that within these constraints little priority was given to social projects, which suffered the most serious lags. We feel that this unfortunate tendency might be exacerbated in the run-up to the general elections and would urge the authorities to do their best to implement projected outlays in the years to come.

On structural policies, we are disappointed by the slow pace of reform in the financial sector. Progress made in recent weeks and the commitments outlined by Mr. Carstens in his preliminary statement are encouraging, but I agree with the views expressed by Ms. Lissakers and Mr. Abbott that, given the long overdue reforms, it appears unlikely that these commitments will be fulfilled more expeditiously than those made in the past.

I do not question the appropriateness of allowing some time for consensus building, but the opening remarks of Mr. Carstens notwithstanding, the authorities should be aware that, with the general election approaching, it will become increasingly difficult for them to gather support for the reforms that are needed. In this respect though, we support the proposed decision. We feel that aiming at the completion of the prior action at the October review may not be realistic, and chances are that, whatever will be left undone by early July, when the congress session resumes, will probably have to wait until after the election. There is no need to stress the dramatic implications such delays would have.

Another area where developments have been somewhat disappointing, is governance. Obviously, it would have been unrealistic to expect a major turnaround in this respect since the last review, and we acknowledge that the government has taken initiatives in the right direction. However, we feel that the seriousness of the problem is such that those initiatives may not be nearly sufficient. In our last discussion, Mrs. Del Cid-Bonilla argued quite convincingly that the findings of Transparency International were not reliable. However, since then, these findings have been substantiated by a harsh report from the national Human Rights Commission, by a number of high profile corruption cases, and by a Gallup poll showing that 90 percent of Hondurans regard their country and its public sector as plagued by corruption. If anything, this shows that the government must take bolder and broader measures than the ones adopted to date. Failing to do so would not only curtail foreign private investment but seriously put at risk the external sustainability of current policies, to the extent that they are heavily dependent upon continued flows of assistance funds.

On the Interim PRSP, the Fund and Bank staffs are to be commended for the quality and candor of their assessment, which we fully endorse. My comments will aim at adding emphasis on issues which are of special significance in the view of this chair.

The authorities managed to gather data on poverty and to produce a thorough diagnosis, which is a prerequisite for a good PRSP. This is a welcome achievement. Nevertheless, from the diagnosis to the strategy, there is a long way to go and we would have liked to find out more, even at this interim stage, about the authorities' concrete plans to tackle poverty in the years to come, particularly on the way in which they prioritized the different areas of development, and how they identified the concrete projects for which they intend to use the relief that will be brought about by the enhanced HIPC Initiative.

There is however one strategic orientation in this PRSP with which we are quite uneasy. It relates to the issues of growth enhancing processes and the

correction of inequalities. There seems to be an underlying suggestion that there is not only a tradeoff between the two but that there is mutual exclusion, forcing the authorities to choose one or the other. We are convinced, on the contrary, that those two avenues of policymaking are mutually reinforcing and should be pursued with equal determination—and there is plenty of evidence to support that view. If I may make a suggestion at this stage, I think the low level of direct taxation, at about four percent of GDP, leaves sufficient scope for action. Due consideration should be given to these issues.

We are even more uncomfortable with the statement made on page 33 of the Interim PRSP according to which 'no extensive study has yet been done in Honduras to show that increased democratic participation has been a favorable factor in poverty reduction'. This may well be true, but it misses the point. Democratic participation is an end in itself, and failure on the part of the authorities to see this gives the distressing impression that they only pay lip-service to the idea of a participatory process and the goal of empowering the poor. I am somewhat reassured by the introductory comments made earlier by Mr. Carstens, but I would appreciate to hear the staff's views on that matter.

Mr. Josz made the following statement:

Honduras is gradually regaining the path of successful stabilization and rapid economic growth from which it was dislodged by Hurricane Mitch. All performance criteria under the present program have been met with the exception of a small, Y2K-related excess of base money at the end of 1999, for which a waiver should be granted.

Of course the authorities still face many challenges:

Although inflation is declining in absolute terms, it continues to exceed that of most of Honduras's trading partners, so that a flexible exchange rate is needed to maintain export competitiveness.

Unemployment and poverty are still extremely high.

Disregarding transfers, the current account deficit and budget deficit are large.

Honduras's external debt is unsustainable.

The quality of such important public policies as social security, health care, and education is poor.

The business environment suffers from excessive financial intermediation costs, overregulation, and notorious corruption.

The Memorandum of Economic Policies for the third year of Honduras's PRGF-supported arrangement, and the Interim Poverty Reduction Strategy Paper, provide excellent plans for improving policies in all the above areas.

The Memorandum rightly points out the need to control the future behavior of public wages now that they have been realigned with private sector wage scales. It will be crucial to contain public sector wages to keep them from derailing medium-term fiscal viability, inflation reduction, and poverty reduction. This will be a major challenge during the upcoming election cycle.

The progress made in privatizing the telecommunications industry is also welcome. I support the authorities' request for more time to muster the consensus needed to secure passage of the laws allowing the reform of the electricity sector.

Honduras needs to give more latitude to private enterprises, including foreign enterprises, so that the relatively high rate of capital formation can boost the economy's low productivity. And an overhaul of social and education policies is needed to increase the economy's productive potential.

The Interim PRSP can be a useful vehicle for building consensus for the drastic changes that poverty reduction will require in many economic and social policies. Honduras's recent history, rich in experiences, can provide the basis for a broad dialogue with the executive, legislative, and judiciary branches of government, with municipalities, with business and trade union leaders, and with NGOs, on the subject of social and economic policies. I share the belief of Ms. Lissakers and Mr. Abbott that the authorities will have to work with the social partners to ensure that the core labor standards established by the ILO are observed by the privatized entities.

Concerning the Interim Poverty Reduction Strategy paper, I have four comments or questions for the staff.

The unequal distribution of land in Honduras has forced large numbers of small holders to settle in areas poorly suited to farming and livestock raising. This has created a vicious circle of poverty and environmental deterioration leading to more poverty (EBD/00/32, page 30). So far, the Interim PRSP pays little attention to rebalancing the distribution of land. This is an area where there is much room for improvement.

Economic growth has less effect on poverty in Honduras than in the rest of Latin America. The authorities conclude that per capita GDP growth will have to increase substantially in order to reduce poverty (EBD/00/32, page 52). I agree with this conclusion as far as it goes but I think we need to

find out why Honduran poverty is more resistant to growth than poverty elsewhere, and what the authorities can do to spread the benefits of growth.

Participatory Poverty Assessments are a technique developed by the World Bank that asks the poor to express their views on causes and remedies for poverty freely, instead of by choosing among a limited number of preformulated answers. This free-form approach does not seem to have been used so far in Honduras. I recommend that it be used in preparing Honduras' full-fledged PRSP, since it has been useful in improving policies in many other countries.

I was a bit surprised to learn that most programs aimed at helping the most vulnerable groups in Honduras are short-term and temporary (EBD/00/32, page 70). It has become generally understood elsewhere that it takes more time, not less, for measures and programs aimed at the poorest groups to succeed, due to the greater number and severity of the problems they confront. This is still another way the PRSP could be improved.

Mr. Singh made the following statement:

Like other speakers, we wish first of all to commend the authorities for their success in maintaining macroeconomic stability, following Hurricane Mitch. In 1999, the fall in GDP growth has been lower than expected and inflation has been kept below the original program target. Fiscal performance has been strong and international reserves could be kept at an adequate level. We therefore share the staff's view that the country's general performance is positive and we can go along with the proposed decisions.

This good performance remains, nevertheless, fragile, and this not only because of the economy's vulnerability to external shocks, but also because of the risks associated with the electoral cycle. In this respect, Mr. Carstens' introductory remarks are welcome. In our view, the sustainability of macroeconomic stabilization and progress in growth and poverty alleviation could be jeopardized, if reform efforts are not maintained and strengthened especially in the fiscal area, on the structural front and on governance issues.

In the fiscal area, as Mr. Josz just pointed out, it is critical that the public sector wage bill be contained. We thus welcome the perspective of a comprehensive civil service reform. Tax administration needs also to be strengthened, and with regard to customs, it is important that measures to improve governance be taken.

On structural reforms, the record so far is mixed. While there has been good progress in financial sector reform, there have been delays in privatization, in particular of HONDUTEL and ENEE, as well as in social

security reform. As the election period gets closer, it will be increasingly difficult to reach a consensus on these sensitive issues.

On governance and transparency, I would like to associate my Chair with Mrs. Mateos y Lagos' comments. The program rightly mentions governance and transparency as critical issues. It is, therefore, disappointing to find so little emphasis and detail on what was identified as the major problem area at the recent Consultative Group Meeting in Tegucigalpa, namely the reform of the judicial system. We hope that the Good Governance strategy to be presented in June will lay out a calendar of clearly identified measures.

Sustained growth rates of 5-6 percent, as envisaged in the program, and substantial poverty alleviation can only be achieved if the conditions for the development of a healthy private sector are established. This means a well-functioning and efficient financial sector, a well-enforced judiciary framework, as well as the removal of distortions impeding investment and exports.

Let me turn now to the Poverty Reduction Strategy. We agree that the Interim PRSP contains the necessary elements identified in previous Bank-Fund documents. It also provides a good basis for the participatory elaboration of a full PRSP, and we can thus endorse it. We also broadly agree with the staff assessment of its strengths and shortcomings.

The most critical point in our view is the need for the strategy to be better integrated with the 3-year macroeconomic framework. This would imply the full costing of the strategy and the identification of the medium-term spending needs. The budget process must play a central role in this respect. The forthcoming Public Expenditure Review ought to provide information and recommendations on the elaboration of a medium-term expenditure framework by establishing priorities and their costing sector by sector.

Financing sources must then be clearly identified, be they tax revenues, grants, or debt relief, in a manner consistent with the macroeconomic framework. In addition, the PER should provide recommendations to increase the transparency, accountability and efficiency of the budget process by establishing a framework for monitoring budget performance.

In all these areas, useful lessons can be learned from the experience of other countries, for example from Uganda and Tanzania. We would like here to mention in particular the positive experience made with surveys of the poor in Uganda, asking them to identify the main causes for their poverty and possible remedies.

As far as risks are concerned, an important aspect which should be tackled more explicitly in the paper is the limited institutional capacity, particularly at the district level. This constraint is all the more important as effective decentralization is a key element for the successful implementation of the PRS. Needs for technical assistance and capacity building could be jointly identified by civil society, government and donors.

Another comment we would like to make relates to the participatory process so far, and as envisaged for the elaboration of the full PRSP. While we fully understand time constraints, we note that the present document was not discussed with civil society. A regular consultation process should be established as soon as possible, and concrete options for involving civil society in the monitoring of the PRS implementation should be explored.

A key challenge in the elaboration of a participatory PRSP is clearly the ability to keep the process focused and to define a small set of key priorities. While we understand that at this preliminary stage it is difficult to identify clear targets, key strategic priorities should be specified as early as possible, and consensus should be built around those priorities.

To conclude, let me wish the Honduran authorities all the best in their future efforts.

Mr. Sdrilevich made the following statement:

We welcome the progress of the program and the authorities' preparation of the Interim Poverty Reduction Strategy Paper. In the wake of a difficult situation, we would like to commend the authorities for their skillful management of economic policy, which has led to better-than-expected macroeconomic results, and a strong fiscal position. We are therefore glad to support the proposed decision.

In broadly agreeing with the balanced appraisal of the staff, we would like to make a few remarks.

We are concerned that the authorities might not be giving the right weight to the extent of the real appreciation of the currency as measured by the real effective exchange rate and the consequent loss of competitiveness. In our view, this concern, also raised by the staff, is not convincingly put to rest by the behavior of exports, which is not satisfactory, nor by the level of the minimum wage in dollar terms. The latter has been stable in the last couple of years, but has shown an increase of around 40 percent since 1996. The current real appreciation of the currency could be judged excessive, particularly if seen against the adverse movement in terms of trade, which have affected the exports of traditional agricultural goods in recent months.

We continue to find a strong contradiction between the high level of aggregate investment and the overall growth performance. This imbalance appears even larger when compared to the annual population growth of about three percent, which, in large part, explains output growth. In the 1998 background paper, the staff explained this pattern in terms of the low level of human capital and the poor quality of investment. We wonder whether, in addition, the investment-output imbalance could result from an incorrect classification of government capital expenditures. Comments on that by the staff would be appreciated.

With regard to the performance under the program more specifically, together with other chairs we find progress in structural reform excessively slow. We note that the authorities have made many commitments, but also that the number of concrete actions taken falls well short of the number of commitments made before. The delay in the approval of the electricity framework law is not comforting. We urge the authorities to accelerate the pace of reform and to avoid any further slowdown related to the political needs of an overly long electoral campaign. The political cycle should not generate policy slippages that the country can ill afford. This, of course, applies also to fiscal policy, which, thus far, has been conducted rigorously by the authorities.

Turning now to the I-PRSP, we agree with the staff on the need for further work, for which there will be ample opportunity in the time schedule for the PRSP, which is appropriate. In particular, the causes of poverty will have to be carefully analyzed. In this regard, more attention should be paid to the issue of persistent income inequality—an extremely serious problem in Honduras. In this regard, I would like to associate myself with the comments made by Mrs. Mateos y Lago. Lastly, a full-blown strategy linking the causes of poverty to the planned remedies will have to be developed, also exploiting the lessons learned from past attempts at reducing poverty.

With these remarks we wish the authorities continued success.

Mr. Kranen made the following statement:

We support the completion of the second review and we have no objections to granting the requested waiver. We thank staff for a set of well written papers and useful information about recent developments, which we received yesterday.

Honduras has done well in coping with the challenges in the aftermath of Hurricane Mitch. We commend the authorities for maintaining their prudent policy under the current program in an unfavorable environment. The

encouraging recovery of the economy has also been assisted by the unique and generous support of the International Community.

Since we are in broad agreement with the staff appraisal, I would like to confine my remarks to the exchange rate, the income policy and the Interim Poverty Reduction Strategy Paper.

On Exchange rate policy:

Due to the massive capital inflows in the aftermath of the devastation caused by Hurricane Mitch the exchange rate has come under pressure. If this upward pressure further persists the competitiveness of the Honduran export industry might suffer. Staff is right when it pleads for focussing on measures to raise productivity in order to maintain the competitiveness of the economy. However, it is somewhat difficult to assess whether the main focus should be put only on internal adjustment. In this regard, the strategy of the authorities to build up foreign reserves will help to alleviate the pressure on the exchange rate. Although we see that inflation risks would be connected with this approach, we nevertheless think that the capital inflow is a temporary phenomenon which should limit these risks. However, as soon as the capital inflows decrease, the authorities should follow staff's advice and should consider a more market determined flexible exchange rate system.

On income policy:

We share Mr. Josz's and Mr. Singh's concerns that the main challenge for the authorities is to regain control over the growth of the wage bill. Annual wage increases of 10 percent in real terms in the public sector are clearly not sustainable. In light of the need to adhere to the revenue targets and against the background of the upcoming election cycle we are somewhat concerned whether the authorities will be able to resist the temptation to relax fiscal policy in order to preserve social peace in the public sector.

In concluding, I would like to add a few remarks on the Poverty Reduction Strategy Paper. We are quite impressed by the broad and comprehensive approach the authorities have chosen. Their efforts to give the civil society and NGOs a real opportunity to participate in the formulation process are clearly visible. However, the time schedule with regard to the completion point of the HIPC Initiative seems to be a bit ambitious since cost-estimates, intermediate targets and a clear timetable have not been developed yet.

Finally I wish the authorities further success in their efforts.

Mr. Kelmanson made the following statement:

On the issue of the second review under the PRGF-supported program, I have no comments in addition to those that have already been made and will therefore focus my comments briefly on the I-PRSP. The I-PRSP is a solid document, and the authorities should be commended for it. However, we would like to raise one general issue and a few more specific points relating to the development of the full PRSP. On the general point, the PRSP was intended to prevent holding up the process of debt relief. As an immediate short-term step its main objective was to provide a road map to a full PRSP. I am not sure as to whether this element was sufficiently emphasized in the I-PRSP that we have before us today. More specifically, the poverty section of the I-PRSP is strong, but, as has been noted by others, the link between the diagnosis and the strategy for actions intended to reduce poverty is weak. We hope that this link could be enhanced in time for the full PRSP.

The second issue is more in the area of the World Bank's responsibility, but it seems worth noting that there is currently little discussion about the qualitative issues that are important to the poor—a point also raised by Mr. Josz. Qualitative studies have shown that violence has a substantial negative impact in this context. Poor governance could have a negative impact on the lives of the poor in restricting service to them and in reducing their economic opportunities. We think this would be an area for additional consideration in the full PRSP. Additionally, the treatment of gender is welcome in the document, but we would like to see that implemented throughout the whole document rather than in a single gender-related section.

The annex on monitoring fails to mention the involvement of civil society and the important role of the municipalities in this process. This concerns a number of levels, given the importance of the governance agenda in this case, which a number of Directors have already mentioned.

Related to this, and in reference to a point raised earlier by Mr. Abbott, there is a need to ensure transparency in policymaking, but also in the budgeting process, and particularly with regard to public expenditure. It appears that this issue is brought more to the fore in the context of HIPC cases where donors and multilateral financial institutions put countries under pressure to ensure that the resources provided are spent in the way they are intended to be spent. In that context, the focus on poverty reduction is particularly important.

Ahead of the decision point for Honduras, it appears important to stress the need to show precisely which resources the enhanced HIPC Initiative will be freeing up. It would be useful to include in the staff report for the decision point a table setting out the debt service actually paid before and

after the relief associated with the enhanced HIPC Initiative becomes effective. Also, it would be important to see clearly set out plans for how freed-up resources will be spent on priority areas. That would provide the Board and other donors some comfort with regard to the effective use of resources and gives donors a helpful indication in determining where assistance is being provided and where assistance should be focused in the future.

Mr. Macia made the following statement:

Once again we would like to express our sympathy to the Honduran authorities following the destruction caused by Hurricane Mitch and wish them continued success in the restructuring of its economy. Given the strong fiscal and monetary policies, the reconstruction efforts, and an improved external environment during the second half of 1999, it was possible to contain the decline in real GDP to 1.9 percent, significantly less than the programmed level of 3 percent. Also, inflation remained well under control and below the programmed target. Financed by foreign direct investment and concessional resources, the external current account deficit reached 5.8 percent of GDP, well below the 9 percent of GDP envisaged in the program. Net international reserves increased above the target, and gross international reserves remained at a comfortable 4.3 months of import cover.

Notwithstanding the above positive developments, the Honduran authorities need to press ahead with improvements in many areas, especially in the legal system, emphasizing the elimination of the poor enforcement of contractual rights, and simplifying requirements for the establishment of new companies. In addition, to improve the business environment, labor regulations need to be revised and constraints on investments and trade procedures improved. We would like the opinion of the staff on the economic results perceived following the conclusion of the program to rehabilitate and revitalize macroenterprises and small and medium-sized enterprises, and the status and potential impact of the proposed tax incentive law for these enterprises.

While the medium term shows positive signs of stable recuperation, prudent fiscal policy is at the heart of such effort. Vigilance on nonsocial expenditures should continue, and reforms on the wage bill policy, and the approval of the Civil Service Law by end-October 2000 are actions that will strengthen medium-term fiscal viability. We welcome the decision of the authorities to curtail nonsocial current expenditures beyond the established targets should revenues fall below program objectives, and to set caps in transport and electricity subsidies.

Strengthening the financial sector is essential for sustained growth and to increase the efficiency of monetary management. To this end, prompt

action is needed to improve inefficient banking practices, strengthen the regulatory framework, and enforce further banking supervision. On the other hand, the authorities' commitment to a gradual shift to market-based instruments and to foster less reliance on nonremunerated reserve requirements to pursue market-based interest rates, are steps in the right direction.

On structural reforms, we congratulate Mr. Carstens and Mrs. Del-Cid Bonilla for the thorough explanation on such issues and we welcome the airport concessions, the prospects for the approval of the framework laws for the electricity, and the sewage sectors. Mr. Carstens' words this morning are well taken given the possible delays for the approval of these laws. We also look forward to the deregulation of the transport sector and the push ahead of the seaport concessions. In social security, we are encouraged with the separation of the pension and health funds, and the draft law to regulate private pension funds to be submitted to Congress by end-of-year. We also commend the authorities for the decision to set aside the proceeds from the privatization of Hondutel together with foreign reserves, and using the interest yields for social investment.

We commend the authorities for the implementation of the integrated financial management system and the strengthening of the government procurement system. On major policy issues, the Honduran government is committed to improve governance and to gradually adopt the Fund's transparency codes. We look forward to the full implementation of these measures and improvements in institutional capacity building, as they will become part of the effort to develop and execute a Poverty Reduction Strategy with the support of the HIPC Initiative. Finally, we are in agreement with the proposed waiver and completion of the second review under the PRGF in light of the progress achieved. We wish the authorities continued success in this endeavor.

Mr. Mirakhor made the following statement:

I join other Directors in commending the Honduran authorities for achieving and maintaining macroeconomic stability in the wake of the Hurricane Mitch and for their observance of most of the structural and quantitative performance criteria.

Notwithstanding the valid points raised in Ms. Lissakers's and Mr. Abbott's statement as well by other Directors regarding the substance and the process of PRSP, the authorities should be commended for the credible effort exerted in producing the interim PRSP. I thank the staff for the well-written report, and Mr. Carstens and Mrs. Del Cid-Bonilla for their comprehensive and helpful statement. I concur with the thrust of the staff's appraisal as well as their assessment of the interim PRSP; particularly

poignant is their assessment of short- and medium-term risks to the program. I share Mr. Bernes's view that the near-term challenge for the authorities is the containment of the wage bill. Also crucial is ensuring that the election cycle does not endanger sustainability of the fiscal policy and the momentum of the structural reform. Assurances given in this regard in Mr. Carstens's and Mrs. Del Cid-Bonilla's statement, as well as in Mr. Carstens's opening remarks, are comforting.

I also share the concerns of Mr. Bernes on the need for a well-articulated framework for monetary policy implementation.

With these remarks, I support the proposed decision, look forward to the discussion of decision point on the HIPC, and wish the authorities all the best as they strive to meet the social and economic challenges facing Honduras.

Mr. Barro Chambrier made the following statement:

It is encouraging to note that the Honduras authorities have been able to reverse the difficult economic situation left behind by Hurricane Mitch, and that progress has been made in many areas, including macroeconomic stabilization, and structural reforms. Furthermore, thanks to the strong support of the international community, the economy has benefited from foreign financing inflows that have helped in the reconstruction efforts. We are pleased to note that all performance criteria except one were observed, and we welcome the indication in the staff supplement that fiscal and monetary policies are on track and that the outlook for 2000 remains positive. We agree with the requested waiver and support the proposed decision.

Despite these positive achievements, Honduras economy continues to face daunting challenges and remains vulnerable to exogenous shocks. Structural reforms are an area where more attention needs to be devoted. In that sense, we are encouraged by Mr. Carstens' preliminary statement, and the authorities are encouraged to redouble their efforts in completing reforms under way in the financial sector, particularly in the social security and the banking systems where management remains weak and reforms are often delayed. There is also a need to speed up the privatization process of large public enterprises.

Fiscal prudence should also remain a priority, and here we support the call of the staff to maintain a firm stance to restrain nonsocial expenditure, and like Messrs. Josz and Singh, we are of the view that public sector wage bill should be contained. In this regard, we note the concern that the upcoming presidential elections could weaken fiscal policy and structural reform, and encourage the authorities to maintain their resolve so that the medium-term objectives can be achieved.

Deep reform is needed in the financial system where risks are important due to uncertainties with legal system. We associate ourselves with the call to reduce risks in the near future and get banks to comply with capital adequacy ratios. We fully agree that the private sector be allowed to bear losses in relation to failed banks in whose operations it has been involved.

For the medium-term, we continue to encourage the authorities for focusing on far-reaching structural reforms and poverty reduction through the Master Plan for Reconstruction and Transformation (MPRT) designed to rebuild the shape of the country severely damaged by Hurricane Mitch. In this regard, the Interim PRSP which is quite comprehensive can contribute to lay a solid foundation for closer dialogue among the Honduran population. It indicates the authorities' clear commitment to poverty reduction, and we agree with the recommendations made by previous speakers with regard to strengthening the full PRSP. Furthermore, issues related to income inequality and land distribution may need to be given more consideration.

In conclusion, Mr. Chairman, notwithstanding the remarkable progress made to get the economy back to normalcy, and despite the good prospects for year 2000, Honduras will continue to require concessional capital inflows.

Mr. Alosaimi made the following statement:

It is heartening that the Honduran economy is on a recovery path with the Fund-supported program broadly on track. This is a commendable outcome in the face of difficulties caused by Hurricane Mitch. As I broadly agree with the staff appraisal, I will only add a few brief remarks.

First, while the standard indicators show that the economy remains competitive, the picture is less bright when account is taken of the broader business environment. As staff notes in paragraph 9, start up of a new company takes several months in Honduras, compared to only a few weeks in neighboring countries. This is a measure of the complexity of the country's business regulations and formalities. As shown in Box 3, problems in this area have a high adverse impact on growth and poverty reduction goals. I will therefore appreciate staff elaboration of prospects for progress in this regard.

Second, I share the cautionary emphasis given by staff to inflation risks from wage pressures. The recent and prospective increases in the public wage bill as percent of GDP is thus a concern. The ongoing rationalization of the wage structure, including introduction of clear rules for public sector employment and wage setting, is therefore a priority.

Third, I agree that faster structural reform and better-targeted social programs are critical for sustained higher growth. Here, the envisaged health

and pension system reforms, and the more proactive approach to privatization are welcome. Success of the effort critically depends on an effective legal system with strict enforcement of property and contract rights. While inadequacies in this regard are referred to in Box 5, the matter clearly deserves higher priority and should have been highlighted in the staff appraisal.

Finally, I agree that the interim PRSP provides an adequate framework for continuation of the Fund program in Honduras. As staff notes, it is difficult to bring disparate interests into agreement over a workable PRSP. Nonetheless, like others, I am reasonably confident that the full PRSP will be completed as expected in early 2001 as, assured by Mr. Carstens. Here, I wish to share the concerns that Mr. Carstens, Mr. Mirakhor, and Mr. Rustomjee have expressed over the burdens that the PRSP process implies for the beneficiary countries. This requires close attention and appropriate flexibility not just for Honduras, but for other countries as well. The summing up should therefore reflect these concerns.

With these remarks, I support the proposed decision and the requested waiver that will now be set as a prior action for the third review.

Ms. Manalac made the following statement:

At the outset, I wish to express this chair's support for the authorities' request for a waiver of the end-December performance criterion on base money, the postponement of prior actions in the electricity sector to the third review of the program, and the completion of the second review under the PRGF. It is encouraging to note that the decline in economic activity turned out to be smaller than anticipated and that inflation, international reserves, and the fiscal deficit were better than expected. However, while macroeconomic indicators currently point to further improvements and while structural reforms are underway, I concur with the staff that the situation remains fragile, as the authorities continue to face a number of challenges. I only have some requests for clarifications on certain aspects of fiscal policy.

Staff have stated that much of the good performance in 1999 was due to one-off factors. Consequently, medium-term fiscal sustainability will only be ensured by maintaining a good revenue performance and containing current nonsocial expenditures of the central government. In this connection, the authorities are urged to continue efforts at strengthening tax administration and adhering to the program with regard to containing the public sector wage bill, particularly in view of the upcoming election cycle. With regard to the latter, I note that one of the measures contemplated by the authorities to help contain the wage bill at nine percent of GDP includes the offer of voluntary early retirement financed with adjustment aid. As this measure in itself would entail a one-time cost for the government, I wonder whether programmed

expenditures for the year have taken this into account. The staff's comments would be appreciated.

The completion of the draft criteria for wage setting in the central government bureaucracy, as stated in Mr. Carstens's and Mrs. Del Cid-Bonilla's preliminary statement, is a welcome development. I would, however, appreciate an update on the status of submission of these criteria to staff for their comments, which, according to the staff report, was scheduled for end-April.

Mr. Rustomjee made the following statement:

Honduras deserves to be commended for the encouraging economic performance in 1999 despite the lingering impact of Hurricane Mitch. Economic activity is recovering; inflation has declined to the lowest level since 1992; the foreign reserve position has continued to strengthen; and the fiscal and current account deficits were better than programmed. With all the end-December 1999 quantitative performance criteria having been met, the program has remained broadly on track. The only exception, the target for base money, was just exceeded by a small margin due to peculiar difficulties associated with Y2K requirements. We therefore support the authorities' request for a waiver of the performance criteria on this monetary aggregate.

We are glad to note that the program for 2000, to the extent that it signifies the authorities' continued commitment to reform, offers many important promises. In this regard, we welcome the authorities' determination to continue their effort at achieving faster, poverty reducing growth, given that more than half of Hondurans live below the poverty line and that the GNP per capita, which is the third lowest in the region, has failed to keep pace with the growth of the population over the past decade. The envisaged increase in spending on social sectors can have a salutary impact on the effort to improve the efficiency of investment that has been low, reflecting poor human and physical capital, despite high investment-to-GDP ratios. In this connection, we welcome the authorities' determination to contain nonsocial current expenditures, particularly in an election year when pressures to raise such expenditures can be great.

While faster growth is needed to combat poverty, gains to be made on the inflation front will also have added beneficial impact. We therefore welcome the focus on continued monetary prudence and on enhancing the efficiency of monetary management through the adoption of market-based instruments. This should also facilitate the lowering of the already high lending rates which, if left where they are, can dampen investment and interest-sensitive consumption and also have additional adverse impact on the domestic financial sector.

Structural reforms will be a key component of the effort at attaining robust sustained growth. Continued progress with privatization, financial sector reform and deregulation will thus be critical.

Achieving external viability for Honduras will be a difficult task. It heavily depends on measures to reduce the external debt burden to a sustainable level. In view of the continued vulnerability of the external sector to exogenous developments, above all, the concerted effort of Honduras' creditors will be required, to provide debt relief on appropriate terms. We therefore look forward to seeing Honduras reach the HIPC decision point within 2000.

In concluding, let me thank all those involved in the preparation of the informative Interim Poverty Reduction Strategy Paper. The work already done should facilitate the preparation of the full PRSP which is expected to be completed by March 2001.

Finally I would like to comment on some of the issues raised during this morning's meeting. Firstly, I much welcome Mr. Carsten's reassurances in regard to continuity and commitment by the authorities in the period through to the elections. Secondly, we have heard many colleagues speak of the importance of full participation and ownership. Several have pressed for the widest possible spectrum of views on poverty reduction and indicated that we need to ensure that the poorest sections of Honduras' population have their views on poverty heard.

While we agree with these sentiments fully, the difficulty is that this brings with it at least three among many conundrums, which in my view are not fully addressed as we build our experience with PRSPs and the PRGF. The first of these is that implicit in all these requests for fuller ownership and for consensus building is the time-frame. On the one hand, consultation takes time; on the other, the country cannot wait forever to conclude the PRSP. Where do we draw the line? We do not spell this out well; and we compound the difficulty for the country by asking for a seemingly endless range of participatory consultations with all facets of society. We need a balance here, and we need to recognize that when we speak of ownership, we really mean that it is the authorities themselves who must finally decide who will be consulted.

Thirdly, there is the conundrum that all this consultation implies costs, and there is an expectation that the concerned countries have the capacity to cover such costs. Just this morning alone in the single instance of Honduras, we have heard an impressive range of requests for income surveys, surveys of the socio-economic conditions of the poor; of rural communities. There is a key dilemma here. These surveys may be important; but they take time and money; and they require capacity. And yet we are asking for these surveys and

for this new information for the PRSPs, from precisely those who have the least capacity and the least human and financial resources.

Fourthly, there is a paradox at the center of the PRSP and PRGF process: on the one hand we ask for full participation; for the widest possible civil society comment, input, and ownership. On the other, in the final design of the program the country is provided with effectively only one set of options. I share Mr. Abbott's list of features and considerations as we move to the Decision Point. But I believe that it would greatly improve the final product, if a range of policy choices, instead of a single choice, were set out in the PRGF and in the PRSP. It would be more realistic, more clearly rooted in the reality that poverty reduction is addressed not through a single strategy, but through a range of strategies.

I would therefore like to conclude by supporting the realities raised by Mr. Carstens in his opening comments, as they really are central to the outcome of poverty reduction, not just in Honduras but elsewhere.

Mr. Hinata made the following statement:

I support the thrust of the staff appraisal and I will comment on a few points only. It is encouraging that the economic performance has improved despite the adverse effects of Hurricane Mitch and that almost all end-December performance criteria were observed. I commend the authorities on their macroeconomic management. However, I regret that there are delays in implementing reconstruction projects as well as structural reforms. Although I understand that some delays were mainly due to political reasons, progress should be made in those areas in order to achieve sustainable economic growth in the medium-term. More importantly, growth should be driven by investment in the private sector. In this regard, I welcome the authorities' commitment to growth-enhancing measures by improving the business environment. I urge them to formally implement those measures, including privatization, such as the sales of the telecommunications and electricity distribution companies, and strengthen the financial system through improvements in banking supervision as well as in prudential regulation. These reforms could contribute to facilitate foreign direct investment. Implementation of structural reforms will also be necessary to reduce poverty. I welcome that the authorities have tackled several outstanding issues in this area. I hope this momentum toward reform will be maintained.

Turning to the I-PRSP, I broadly agree with the staff's assessment. In particular, I share the staff's view on social sector targets, the need for a more detailed analysis, and for policies regarding economic growth and poverty reduction, as well as for identifying the total cost of the programmed policies. I hope that the authorities will complete the full PRSP in a manner consistent with the expected schedule. We welcome that the Fund staff is preparing a background paper on economic and poverty issues for Board discussion at the

next Article IV consultation. I would expect to see theoretical and empirical analyses on the linkage between the macroeconomic framework and poverty.

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

The staff representative from the Western Hemisphere Department, responding to questions raised by Mr. Abbott on the participatory process and on lessons to be learned from the delay in passing the electricity law, considered that the time needed for consensus building had sometimes been underestimated by the authorities. Also, interest groups were often rather well informed about developments in other countries. In Honduras, skepticism among interest groups with regard to certain projects under the program had arisen, partly owing to information about similar developments underway in Costa Rica. The result of such developments was an increased need for time to ensure that all parties participating in the process could have a full understanding of the measures under the program.

The postponement of prior actions relating to social security reform could serve as an example that a more complete understanding on the part of civil society was achieved at the expense of timeliness, the staff representative remarked, but the postponement also helped ensure that there was a degree of ownership and commitment to the measures in question which was much higher than could have been achieved had they had been passed more rapidly and while wide disagreement persisted. Some delay might thus be the price that the Fund had to pay in exchange for a higher degree of ownership of the reforms. It was hoped that those issues would be resolved in the PRSP process, given that it was one purpose of the PRSP's participatory nature, to discuss policies and to forge some consensus that would be reflected in the implementation and in the overall strategy of the authorities.

On the question about the quality of the participatory process within the context of the I-PRSP raised by Mr. Abbott and others, the staff representative considered that there appeared to be a genuine effort on the part of the Honduran authorities to consult all parties concerned. However, at times the number of groups concerned would rise to several hundred, making the inclusion of each of them practically impossible. There were added difficulties, given that views among those groups were rather diverse and given that some of them even rejected the notion of a market economy altogether. In the face of such difficulties, the authorities were trying to do their best to hear as many views as possible. That process would continue during the preparation of the full PRSP.

Responding to questions on measures taken to strengthen the legal system, the staff representative noted that the matter was a rather new issue for the staff and that experience still needed to be gained through the close cooperation with the World Bank and the Inter American Development Bank, as well as with some other donors. The main issue of concern to the staff was contract enforcement, particularly in the banking system. Deficiencies in that area were one cause of the wide interest rate spreads. Various proposals were currently under discussion with regard to that problem. However, it would take time to analyze those issues with the necessary attention to detail.

Responding to questions on monetary policy, the staff representative noted that the monetary authorities had in the past relied primarily on two instruments—non-remunerated reserve requirements and obligatory investments. Banks were required to hold non-remunerated reserves at about 12 percent of deposits and make obligatory investments covering about 13 percent of deposits, with both instruments thus covering about 25 percent of total deposits. The authorities had been gradually lowering the compulsory investment requirement.

Among open market operations, Central Bank Certificates of Absorption (CAMs) were the dominant instrument, the staff representative informed. Their interest rate of about 10 percent was market-related, while the compulsory investment requirements had carried an interest rate well above market rates of about 14 percent, and therefore, caused some distortion. Its gradual reduction aimed at establishing an operational interest rate for monetary policy more in line with the market and at freeing up banks' resources, giving them more freedom to make investment decisions. The hope was also that banks' spreads would narrow as a consequence, and that monetary policy would become more flexible in the absence of rediscount rates. While there was a facility similar to a rediscount window, it was not used in practice. It was hoped that among the two policy instruments currently available for open market operations, CAMs would become increasingly predominant.

With regard to the question raised by Mrs. Jul as to whether the program contemplated the elimination of mandatory investment requirements altogether and aimed at full reliance on open market operations, the staff representative said that the requirement was being lowered during the current year from 13 to 7 percent of deposits and that there had not been discussions with the authorities on further reductions. However, it was possible that such considerations would be part of the program in the following year, depending on the experience gained with the gradual adjustment presently underway.

With regard to Mrs. Jul's question about the large share of non interest-bearing assets in the central bank's balance sheet, the staff representative informed that this related mainly to a zero coupon bond that had been issued by the treasury to the central bank during the 1990s with a view to compensating for losses incurred by the central bank in foreign exchange transactions after the devaluation of the lempira. The staff was concerned that, during the transition toward a more flexible monetary policy, the central bank's room for maneuver might be constrained by the fact that those assets did not bear interest. Discussions with the monetary authorities were still ongoing about how to address that problem.

There was another, purely technical problem with regard to the execution of monetary policy, which related to the fact that auctions were still being conducted manually, the staff representative noted. In view of that, there were concerns as to whether it was feasible for the authorities to move to a more flexible exchange rate regime and whether monetary policy was able to effect market-based operations in the absence of electronic links between individual banks and the central bank. It appeared that the technical infrastructure had to be in place before greater flexibility in monetary policy could be envisaged.

On questions concerning competitiveness, the staff representative noted that Honduras was still undergoing a number of temporary shocks which made it difficult to assess changes in competitiveness. Hurricane Mitch had destroyed considerable export capacity, and large capital inflows in terms of external assistance constituted another temporary shock to the system. Also, the existing statistics on productivity and other measures were inadequate. Therefore, the standard indicators for measuring developments in competitiveness were not available. Once those temporary shocks had abated, it would be easier to assess whether the exchange rate was appropriately valued. At the current stage, exports were recovering, which suggested that there was some margin of competitiveness. Also, given the recent approval of trade benefits by the U.S. Congress, increased investment in the maquila sector was expected. If competitiveness were an issue, those investments would occur in neighboring countries. The indications available so far suggested that competitiveness issues were not, at the current stage, a cause for concern. However, the staff would monitor that issue closely to ensure that a decline in competitiveness would not endanger an export-led recovery.

On the question regarding the business law raised by Ms. Jul and Mr. Hendrick, an issue that was also related to the concerns about competitiveness, the staff representative informed that the authorities were planning to submit to congress by end-June a law simplifying business regulations. That should address some of the concerns about competitiveness raised by Directors. The draft bill appeared to be ready and it was likely to be submitted to parliament on time.

Responding to the question on the accuracy of measuring investment, the staff representative considered that the quality of economic statistics in general was not adequate, but that the central bank was working on improving national accounts data with the help of the Fund's Statistics Department. There were two factors that might have led to overestimating investment, one being double counting of building permits, which were used as proxy for developments in construction activity. Another factor was the failure to include the disposal of assets in the gross investment data.

On fiscal policy and the question as to whether the payments for redundancies were indeed included in the program, the staff representative noted that those payments were included in the fiscal account projections.

The staff representative from the Policy Development and Review Department, responding to questions raised by Mr. Abbott on the steps to be taken between the decision and completion points under the enhanced HIPC Initiative, referred to the relevant Board decision that outlined the specific requirements for receiving assistance in that context. According to that decision, the requirements would normally be satisfied by an initial three year performance period leading up to the decision point, which was approaching shortly in the case of Honduras, followed by a second performance period leading up to the completion point, the conditions for which would be satisfied when a member had satisfactorily implemented a set of predefined key policy reforms, had achieved a stable macroeconomic position, and had kept on track with its Fund-supported program. In addition, the member

should prepare the PRSP and implement that strategy satisfactorily for at least one year by the time of the completion point. That was the definition of the floating completion point.

Responding to the question from Mr. Abbott as to whether the conditions for completion would be developed by civil society, the staff representative considered that the PRGF revolved around the PRSP, which is where the consultative is required and is central.

The Acting Chairman, noting the comments made by Messrs. Rustomjee, Abbott, and Mirakhor with regard to the issues of the timeframe, quality, ownership, and the appropriate balance between them in the PRSP process when passing from the decision point to the completion point, considered that those were general methodological concerns that should be addressed in detail by the Joint Committee of the IMF and the World Bank on strategic issues of the enhanced HIPC Initiative, the PRGF, and the PRSP. At the joint meeting of the Fund and Bank Boards earlier during the current week, there had been an active exchange on similar issues. While they could not be discussed extensively in the context of the current Board meeting, management would consider submitting the general comments made by Directors to the joint Fund-Bank committee.

Mr. Mirakhor thanked the Acting Chairman for bringing those issues to the attention of the joint committee and considered it useful if Mr. Carstens's additional remarks at the beginning of the current Board meeting with regard to trade-offs between ownership and quality on the one hand and timeliness and conditionality on the other could be reflected in the summing up of the current meeting. While being of a general nature, those comments were of direct relevance for Honduras. Also, with regard to the questions raised by Mr. Abbott, Mr. Carstens's remarks could serve as points of reference for future Board discussions on similar issues.

The Acting Chairman asked Mr. Carstens to elaborate further on the specific concerns with regard to those general issues in the case of Honduras.

Mr. Carstens clarified that there were two points to which he would like to draw the particular attention of Executive Directors. One was an intrinsic difficulty in the process leading to debt relief under the enhanced HIPC Initiative that consisted in a trade-off between the pace and the quality as well as the ownership of the legislation that needed to be passed by parliament in that context. That also seemed to be the key issue underlying the questions raised by Mr. Abbott and the comments from Mr. Rustomjee. The other point of emphasis was the unquestionable commitment on the part of the Honduran authorities to the PRSP process and their considerable efforts to ensure that that process remained sustainable despite the upcoming election campaign and beyond a possible subsequent change in administration.

The Acting Chairman considered that the assurances on the part of the authorities regarding their commitments to the continuity of their policies should be appropriately reflected in the Chairman's statement. With regard to the difficult trade-off between pace and quality of passing legislation in the PRSP process, he noted that the Board was considering granting a waiver with regard to the electricity framework law with a view to providing more time for consensus building and achieving ownership. Therefore, there did not appear to be a

conflict between the position taken by the staff and the observations made by Mr. Carstens. Also, Directors appeared to support that position to facilitate progress toward poverty reduction on the basis of a participatory process, consensus building, and ownership.

Mr. Carstens considered that he could agree to a summing up that reflected those issues in the way the Acting Chairman had presented them.

Mr. Alosaimi agreed with the position of Messrs. Carstens, Mirakhor, and Rustomjee with regard to the burden the PRSP process put on the beneficiary countries. The ensuing problems required close attention and appropriate flexibility on the part of the Board, not only in the case of Honduras, but also in cases of other countries facing similar circumstances. Therefore, the summing up should appropriately reflect those concerns.

Mr. Carstens made the following concluding statement:

I would like to reiterate our appreciation and gratitude to the staff. As is evident from today's discussion and from the general issues raised by Directors regarding the enhanced HIPC Initiative, we are currently navigating in uncharted waters. In view of this, the close cooperation between the Fund and the countries concerned will help overcome the existing problems. I think that this spirit of cooperation is present in the relationship between my authorities and the staff. Honduras is fortunate in that respect, and I am confident that this close cooperation will be repeated in other cases as well.

With regard to fiscal policy, Mrs. Mateos y Lago commented on the delays in capital expenditures and Mr. Abbott noted that overall fiscal policy was doing well. There were also comments on the public sector wage bill. I would like to address these issues in a broader perspective and point to some general lessons that might be learned from the experience in Honduras.

As far as the delays in capital expenditures are concerned, they can be explained in large part by the fact that, last year, my authorities introduced a strict procurement procedure to enhance transparency. This matter shows once more that we are not operating in a perfect world and that the introduction of measures aimed at achieving one objective might have adverse consequences for the achievement of another objective. The authorities have made a major change to achieve the important objective of enhancing transparency and reducing corruption. Therefore, the government should not be criticized for delays in effecting spending, if those delays are the direct consequence of implementing measures aiming at increasing budgetary transparency. While the introduction of transparency-enhancing measures would preferably be immediate and without any friction, they are not. Thus, the delay in expenditures has to be regarded as a cost associated with improved transparency.

On the public sector wage bill, I share the concerns expressed by my colleagues, but would like to stress that there is the problem of the tradeoff between satisfying basic needs on the one hand and the need for fiscal discipline on the other. The wage bill is rising mainly because of the need for expanding the provision of education and health services. In the recent past, the real salaries of professors, nurses, and other public servants, like judges, have fallen considerably. When the staff met the President of the Supreme Court during the staff mission, he pointed out that the judicial system had been improved, but that judges in Honduras earned only about US\$500 per month. Such low levels of remuneration for judges raise serious concerns and highlight some of the problems entailed in containing the public sector wage bill. The obvious solution would be for the Honduran government to be able to draw on higher revenues generated by stronger growth. However, the process of bringing about higher growth takes time. Therefore, the Board should consider which is the appropriate framework of expectations for monitoring and evaluating the progress made in the different countries. While there is a clear need for an improved judicial system, that objective cannot be achieved without paying judges more than US\$500 per month. However, the measures needed to free up sufficient resources to afford higher quality human capital will take time.

On the comment from Mrs. Mateos y Lago that my authorities were just paying lip-service to the participatory and democratization process with regard to its contribution to growth, the staff has reported that there has not been a study on the impact of democratization on growth. However, the staff report does show that the authorities are going about democratization with the appropriate attitude. It also says that, for the last 20 years, there has been a democratic process in Honduras, which has contributed to growth. A study could be done to investigate this more thoroughly. However, even if the study concluded that the democratization process had not been sufficient to foster growth, it would still be wrong to allege that the authorities were only paying lip-service to the democratization process.

Another issue related to Mrs. Mateos y Lago's comment is the question of how we can measure democratization in the context of the enhanced HIPC Initiative. If it is simply measured in terms of the number of NGOs involved in the process, then we face the problems pointed out by the staff that both the number of NGOs and the differences between their views cannot be reconciled with any measure of efficiency for the overall process.

Mr. Abbott said in his preliminary statement that there should be a two-way communication between civil society and government. While that is true, that demand should not only be made on the authorities, but must also apply to the NGOs. In this regard, I would like to reiterate that there are NGOs that operate neither in a transparent nor in an accountable fashion. While this cannot be generalized, it is an issue of considerable concern when

trying to measure democratization. This has important implications for the government's relationship with Congress, given that Congress operates in a transparent manner, is democratically-elected, and represents civil society, whereas the same cannot be said for NGOs. I do not think it is appropriate to comment on the democratization process in Honduras, unless there is an appreciation of these important lessons to be learned in Honduras and in other countries in my constituency that are undergoing this complex participatory process.

On the issue of external competitiveness, I would like to complement the comments made by the staff by saying that there are other factors which will enhance competitiveness, like the reduction of export taxes, the deregulation of transportation, the streamlining of the process to create businesses, and other reform efforts. As Honduras is experiencing capital inflows, the currency has remained strong. Depreciating the currency with a view to enhancing external competitiveness could however have a negative impact on inflation. It seems appropriate, at the current stage, for the authorities to concentrate their efforts to improve competitiveness on issues that do not directly relate to monetary management. My authorities are fully aware of this issue and are in contact with the staff, should the need arise to take additional measures to address the matter.

Another issue raised by several Directors related to measures promoting growth and a more even income distribution. My authorities are pursuing those objectives in a number of ways, through reducing inflation, promoting exports of labor-intensive products, and through trade liberalization in the context of the Central American Common Market and the free-trade agreement with Mexico. I would like to assure my colleagues that my authorities are actively pursuing this strategy for development.

I would like to thank all speakers for their valuable comments on how to improve the PRSP. I will take note of them and transmit them to my authorities.

The Acting Chairman made the following summing up:

Executive Directors commended the authorities for having implemented politically difficult policies, especially given the complex economic situation and generally the country's low income level. These policies had allowed Honduras to recover from the devastation caused by Hurricane Mitch, while preserving macroeconomic stability. Directors observed that prudent fiscal and monetary policies had contributed to a further strengthening of the international reserve position and a decline in inflation in 1999. Looking ahead, Directors considered that the main challenge facing the authorities is to ensure a transition to higher poverty-reducing growth. This requires further efforts in speeding up structural reforms, improving

governance, and strengthening social programs. Some Directors discussed and saw trade-offs between the speed at which reform legislation could be drafted and passed and the reasonable amount of time needed for consensus building and for creating broad ownership of the program. In this connection, a few Directors also felt that, in preparing PRSPs, the added costs to the country of various survey requirements needed to be taken into account in staff appraisals. More generally, Directors underscored the importance of adhering to policy commitments and reviving the pace of structural reform in the period leading up to the elections, and welcomed the authorities' assurances in this connection.

Directors noted that the improvement in public finances reflected, in part, extraordinary factors, such as the delay in implementing reconstruction projects and one-time increases in revenue. Therefore, additional efforts to consolidate the fiscal position, improve tax administration, tighten budgetary controls, and increase public savings were essential. In particular, Directors stressed the need to control the central government wage bill and to press ahead with the planned reform in public sector wage policy, including the establishment of clear criteria for wage increases. This was seen as a key element to ensure medium-term fiscal viability. Directors also considered that, to better support the poverty reduction objectives, it will be important to improve the efficiency of social expenditure. Directors welcomed the initiation of the social security reform and stressed the importance of proceeding in a timely manner with the government's action plan in this area.

Directors noted the importance of continued monetary prudence. They encouraged the authorities to proceed with the intended reduction in mandatory investment requirements and to increase reliance on open market operations. This should improve the efficiency of monetary management and lower interest spreads in the banking system. Directors welcomed the progress made in strengthening banking supervision and financial sector regulation and urged the authorities to ensure that their actions are in line with international best practices. The rule of law was regarded as essential for the efficient working of the banking system.

Directors recommended the close monitoring of developments in competitiveness. Once the structural impediments to exports associated with the destruction caused by Mitch have been overcome, competitiveness should be assured by containing wage pressures and increasing productivity through structural reforms. Some Directors also recommended a gradual shift to a more market-based exchange rate determination within an interbank market.

On structural reforms, Directors regretted the delay in the approval of the new Electricity Law, which is required for further privatization in the sector. They stressed the need to press ahead with the approval of the law, which will allow increasing private sector participation in electricity

distribution, as well as to complete the privatization of the telecommunications company. Such actions would increase economic efficiency, stimulate private investment, and release resources to help address poverty and basic social needs.

Directors welcomed the authorities' plans to simplify regulations to improve the business environment and to improve governance and transparency of policies. Despite some initiatives, much remained to be done in this area. In particular, Directors urged that the planned governance strategy cover ways to improve the rule of law and the enforcement of contracts.

Directors commended the authorities for the substantive work on the interim Poverty Reduction Strategy Paper (PRSP). They welcomed the involvement so far of civil society and encouraged that the participatory process be strengthened throughout the drafting of the full-fledged national poverty reduction strategy. Directors also emphasized the importance of better integrating the macroeconomic framework and the lessons learned from past policy into future drafts of the PRSP.

The Executive Board took the following decision:

1. Honduras has consulted with the Fund in accordance with paragraph 2(dd) of the three-year arrangement for Honduras under the Poverty Reduction and Growth Facility (PRGF) (EBS/99/37, Sup. 1) and paragraph 6 of the memorandum attached to the letter dated November 12, 1999 from the Minister of Finance and the President of the Central Bank.
2. The letters from the Minister of Finance and the President of the Central Bank dated April 13, 2000, with its attached memorandum and dated May 31, 2000 with its attachment, respectively, shall be attached to the three-year PRGF arrangement for Honduras, and the letters dated March 10, 1999 and November 12, 1999 shall be read as supplemented and modified by the letters dated April 13, 2000 and its attached memorandum, and dated May 31, 2000 and its attachment.

3. Accordingly, the following new provisions shall be added to the PRGF arrangement for Honduras:

(a) The following shall be added to paragraph 1(cc):

‘The fourth disbursement under the arrangement, in an amount equivalent to SDR 16.15 million, will be made available on January 1, 2001 or earlier, upon completion of the third review under the arrangement, at the request of Honduras.’

(b) The following shall be added to paragraph 1(dd):

‘The phasing of, and the conditions for, further disbursements during the third year of the arrangement will be established at a review to be completed no later than December 31, 2000.

(c) The following shall be added to paragraph 2(aa):

‘Honduras will not request the disbursement of the fourth loan referred to in paragraph 1(cc) above, if the Managing Director of the Trustee finds that the data as of end-June 2000 indicate that any of the ceilings and floors referred to in paragraph 2(a)(i) to (v) of this arrangement as specified in Tables 1 to 6 of the memorandum attached to the letter of April 13, 2000 were not observed.

(d) The following shall be added to paragraph 2(bb):

‘Honduras will not request the disbursement of the fourth loan referred to in paragraph 1(cc) if Honduras has not carried out its intentions with regard to the following structural performance criteria:

(i) by end-June 2000, conclude the bidding for Hondutel,

(ii) by end-June 2000, submit to Congress legislation to simplify procedures on company establishment,

(iii) by end-June 2000, enact legislation on Statistics Institute, and

(iv) by end-October 2000, enact Civil Service Reform Law containing criteria for wage-setting in central government, as specified in Table 7 attached to the letter of May 31, 2000 of the Minister of Finance and the President of the Central Bank.

(e) The following shall be added to paragraph 2(dd):

‘Honduras will not request the fourth disbursement specified in paragraph 1(cc) above until the trustee has determined that the review referred to in

paragraph 3 of the letter of April 13, 2000 of the Minister of Finance and the President of the Central Bank has been completed.'

4. The Fund decides that the review contemplated in paragraph 6 of the memorandum attached to the letter of November 12, 1999 of the Minister of Finance and the President of the Central Bank has been completed, notwithstanding the nonobservance of the end-December performance criterion concerning the ceiling on reserve money of the central bank set forth in paragraph 2(a)(ii) of the arrangement. (EBS/00/77, Sup. 1, 6/5/00).

Decision No. 12208-(00/57), adopted
June 7, 2000

2. MOROCCO—2000 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 2000 Article IV consultation with Morocco (SM/00/92, 5/18/00). They also had before them a background paper on recent economic developments in Morocco (SM/00/105, 5/26/00).

Mr. Daïri submitted the following statement:

The passing away of King Hassan II and the crowning of Mohammed VI were the most important events in Morocco's recent history. As expected, the succession went smoothly and according to the constitution; it completed the political transition started by the late King Hassan II when he called upon a coalition comprising mainly former opposition parties to form a new government in March 1998. The new King is extremely popular in view of his well-established record in assisting the poor and underprivileged. He has also demonstrated genuine interest in improving conditions of women so that they can contribute more to economic and social development. The first year of his reign has also witnessed significant progress in further political opening and human rights protection. On several occasions, His Majesty Mohammed VI has confirmed the liberal orientation of the economy and the major role to be played by the private sector.

I wish to thank the staff for their analysis and advice and for the very useful recent economic developments report. I will address briefly some of the important issues, including agricultural policy and the droughts, structural reforms, macroeconomic developments and policies, social and poverty issues, and, finally, exchange rate policy.

At a time when the Government strived for maintenance of political and social stability for a peaceful and democratic transition and continuation of sound macroeconomic and structural reform program, the economy was struck by the most severe drought of the century, which reduced cereal production to one-third of its long-run average. Another drought of the same

magnitude occurred this year, bringing total droughts in the 1990s to the unprecedented number of five.

The staff paper explains the volatility of GDP and agricultural output by the price-support and tariff protection system promoting crops, notably cereals, that are particularly vulnerable to drought conditions. This assessment needs to be qualified. First, the system is not new and goes back several decades, whereas the high recurrence and severity of droughts is a new phenomenon. Second, this system does not guarantee any level of profitability to farmers who have to bear the risks in case of drought. Third, the cultivated area of cereals increased only marginally by 4 percent between 1983-90 and 1991-99, at a time when the total cultivated area increased by 10 percent, therefore there is no indication that there has been significant substitution of drought-prone crops to less weather dependent productions. Finally, land tenure constraints in a large part of the country, including the prevalence of communal land and extreme fragmentation of agricultural properties, make it difficult for small farmers to invest long term. A change in the price-support and tariff protection system without policies to help farmers to convert to less drought-sensitive crops would induce further migration to urban areas, leading to a surge in unemployment and exacerbation of poverty.

The authorities have made rural development one of their top priorities. They are fully cognizant that diversification of the agricultural sector away from drought-sensitive crops, and development of nonagricultural sources of income are closely linked to enhanced access to education, especially for young girls, basic health services, safe water and electricity, and improved infrastructure. Their program in this area is being implemented with the World Bank's assistance and with the involvement of civil society. The authorities are also committed to addressing key structural impediments to agricultural development, including land ownership issues, extension of services to farmers, and access to credit.

To alleviate the short-term effects of droughts on the rural population, the authorities have announced a program focussed on safe water distribution, protection of the livestock, temporary job creation to enhance productive capacity and infrastructure, and debt relief, in particular for small farmers.

Box 1 of the staff report describes the progress made in many areas of structural reforms since early 1999. These reforms required extensive discussion between the Government and the two chambers of parliament as well as several rounds of consultation with economic and social partners and the civil society. Their focus was on improvement of the legal framework for private sector development, including extended scope for privatization, enhanced transparency and simplified administrative procedures, improved governance, strengthening the financial sector, and establishing the legal framework for the implementation of the Government's social strategy. The

authorities' efforts at reaching consensus on major policy issues have been instrumental in speeding up the process of preparation and adoption of structural reforms. The reform of education, one of the key areas of structural weaknesses, was approved in a record time. It took only a year between the creation of the Committee in charge of its preparation and the final approval by Parliament of the necessary legal framework constituted by eight separate laws. This reform, which was prepared with the full participation of the civil society, aims at generalizing basic education and making it mandatory, reducing illiteracy, reorganizing education programs, improving the quality of teachers, enhancing private education, strengthening vocational training with private sector involvement, and further decentralizing the system.

The revised privatization law and the reform of the telecommunications sector opened further the scope for private sector development. The transparent and professional manner in which the sale of the second GSM license was carried out has been cited as an example in several fora. It allowed the budget to benefit from \$1.1 billion, which was three times the amount initially expected. This sale will be followed by several other concessions in telecommunication and the information technology areas. Privatization of the national operator, Maroc Telecom, is proceeding according to schedule and has attracted the interest of major operators. It is expected to generate even larger revenues to the budget.

The authorities attach high priority to the strengthening of the financial sector to improve its efficiency and facilitate its integration into globalized capital markets. In view of the involvement of commercial banks in other financial institutions, the authorities have decided to apply prudential regulations and supervision on a consolidated basis. They will also increase the liquidity ratio to 100 percent and review the capital adequacy ratio in light of the recent recommendations of the Basle Committee. The new accounting regulations, consistent with best international practices, have been implemented on schedule, and the authorities will soon issue regulations regarding publication of financial statements of institutions under their supervision. The nonperforming loans issue will be addressed to a large extent with the ongoing restructuring of two banks. A restructuring program for the Housing and Tourism Bank (CIH) has been discussed with the shareholders and will soon be implemented. A draft law on the restructuring of the Agricultural Bank (CNCA) has been submitted to Parliament.

The task of maintaining macroeconomic balances was all the more challenging in view of the effect of the succession of severe droughts on growth and government revenue. Over the past three years, the "underlying deficit" increased only marginally from 4.3 percent of GDP to 4.9 percent, whereas tax revenue increased by more than 1 percentage point of GDP to 23.5 percent as a result of the restructuring effect of the tax amnesty and related accounting reforms, implemented by end-1998, as well as of the

further strengthening of tax administration. Improvement in budget procedures and control has allowed some savings in nonwage recurrent spending. The increase in the wage bill in 1999/00 was largely accounted for by the lower GDP performance. The wage bill, which was expected to decline from 11.7 percent of GDP last year to 11 percent this year, will amount instead to 12 percent of the lower GDP.

The increase in the "underlying deficit" had no inflationary effect. The large privatization and GSM revenues, combined with nonbank financing, made it possible to finance the overall deficit, reduce bank financing by over 1 percent of GDP, absorb negative external financing of similar magnitude, and virtually eliminate domestic arrears which had reached 3.8 percent of GDP by end-1998. The decline in government bank financing and the elimination of domestic arrears are expected to improve private sector's access to credit and strengthen confidence.

Monetary policy in 1999 was conducted in the usual prudent fashion, contributing to a further decline in inflation. The problems encountered as a result of the unexpectedly large amount of GSM revenue were addressed, and the money market soon returned to normal conditions. In view of the sizable privatization revenue expected by the Government in 2000 and beyond, it is the authorities' intent to maintain close cooperation and coordination between the Treasury and the Central Bank in order to avoid recurrence of such surges in liquidity.

In accordance to the priority given to poverty reduction and to prepare a comprehensive strategy in this area, the authorities have conducted a major survey of living conditions and poverty. The preliminary conclusions of the survey indicate that poverty, which had declined from 24 percent in 1984/85 to 13 percent in 1990/91, increased to 19 percent in 1998/99. While this is, of course, a matter of concern for the authorities, I would like to underline the following. First, the years of the two last surveys are not comparable. While it is true that in both years agricultural production was boosted by good rainfall, the prevalence and severity of droughts in the period preceding the two surveys were different. There were four droughts between 1990 and 1998 as against only one between 1984 and 1990 and their severity increased substantially. Second, the recent survey indicated that the increase in poverty did not originate from higher income inequality, which had remained basically unchanged between the two surveys. This confirms that the increase in poverty resulted from the lower income stemming from the droughts. Third, the methodology used for the last survey is far superior to that for the previous one, and its results are more reliable. This being said, the authorities are preparing with World Bank participation a poverty update based on the recent survey in order to draw an action plan for poverty reduction.

Investment in 1999 recovered significantly to more than 24 percent of GDP, and the authorities are confident that this trend will continue. The interest expressed by foreign investors in Morocco's privatization program, in particular the telecommunication sector, reflects their confidence in the future of the economy and in the authorities' policy stance. It is the authorities' intention to further strengthen this confidence by continuing prudent macroeconomic policies and deepening structural reforms. While much of the increase in unemployment was related to the droughts and is reversible as observed during 1995-97, the authorities expect that the ongoing reforms and their efforts at improving human resources will trigger a supply response and enhance growth and job creation. The increase in public investment in the second half of 2000 and the utilization of GSM revenue in the context of the Fonds Hassan II will play a catalytic role in strengthening private investment.

Since the issue of the exchange rate policy was covered comprehensively in my statement and the Board discussion of last year, I will not devote much space to it here. Suffice it to say that the authorities consider that the current exchange rate policy has served the economy well in maintaining financial stability. The substantial structural reforms and the authorities' efforts at maintaining macroeconomic stability and human resource development, including their focus on education and vocational training and reducing adult illiteracy, are expected to boost productivity and economic efficiency. Moreover, there is no compelling indication that the exchange rate is misaligned. The external position has strengthened significantly in the 1990s, with the current account deficit limited to between 1 and 2 percent of GDP for most of the decade, its financing ensured mainly by non-debt creating flows, and foreign reserves increasing to record levels. These external developments, combined with an active debt management policy, have resulted in a significant improvement in debt indicators. Between 1995 and 1999, external debt to GDP declined from 68 percent to 51 percent, external debt to total current receipts from 192 percent to 139 percent, and debt service ratio from 30 percent to less than 23 percent.

As regards the performance of the export sector, market shares rose from 0.127 percent of world exports in the 1980s to 0.134 percent in the 1990s. Foreign demand in Europe, the main trading area, has not been buoyant. There has been a decline in textile exports, also experienced by other countries as a result of the competition from Southeast Asia and transition economies. Part of the recent decline in export growth also stemmed from weaker performance in fisheries, which is not linked to exchange rate developments. The performance in tourism, which had been less than satisfactory in most of the 1990s, recovered markedly during the past two years as a result of the important reforms in this area. Both the geographic and sectoral distribution of exports is improving, with a significant diversification to new products and, more recently, improved access to nontraditional markets, such as the United States. Moreover, export volumes increased faster

than the average for developing countries in 1998 and even more so in 1999 (4.6 percent and 7.1 percent as against 3.7 percent and 3.6 percent, respectively). While the authorities will continue to closely monitor external and exchange rate developments, they are also cautious not to unduly jeopardize the hard-won gains in financial stability.

Mr. Faini submitted the following statement:

Morocco's economic conditions have deteriorated markedly since the early nineties. This evolution is in many respects surprising. In the early eighties, Morocco successfully implemented an ambitious program of macroeconomic stabilization and structural reform. The program was instrumental in allowing the country to rapidly recover from the consequences of the debt crisis that had hit the country particularly hard in 1983. The recovery was remarkable: boosted by the rapid expansion of labor intensive exports, growth was quite sustained after 1985. The social impact of rapid growth was also favorable. A World Bank report published in the early nineties highlighted the significant progress that had been achieved in the field of poverty reduction. At that time, Morocco held promise to a period of sustained and equitable growth.

What went wrong during the nineties? This is the basic question addressed in this excellent staff report. The response is disarmingly simple: the reform effort was not sustained during the nineties. Trade liberalization is a case in point. In 1983, Moroccan authorities embarked on an ambitious program aimed at dismantling the complex system of tariff and non-tariff protection that had distorted resource allocation and stifled economic incentives. The process met with considerable success but then came to a virtual halt. We learn from staff that the average MFN tariff rate is still as high as 31.6 percent, substantially higher than in many emerging markets. This is an area where Morocco has not made much progress, while other countries have moved forward. Other areas where the reform efforts have stalled include price liberalization, particularly in agriculture, and civil service reform. They are well described in the staff report.

Is the exchange rate policy appropriate? Exchange rate management in the nineties provides a further example of a policy shift with respect to the second half of the eighties. At that time exchange rate flexibility proved to be a key factor in allowing the economy to reverse the previous real appreciation and shift resources toward the traded goods sectors. Conversely, there are good reasons to believe that exchange rate policy during the nineties is responsible for the significant real appreciation of the dirham, almost 20 percent since 1990, and for the stagnation of exports. This is, I believe, one of the key policy issues for Morocco. Let me therefore dwell on it at some length.

Can the real appreciation be attributed to relatively fast productivity growth? The answer is negative. There are no indications that productivity growth had been sustained during the nineties. Moreover, it should be obvious that if, on top of Morocco's labor force growth and high investment rate, the productivity performance had also been sustained, then output growth should have been substantially higher than 3 percent. The lack of productivity growth is also manifest in the abysmally high value of the incremental capital-output ratio, which is a testimony to the fact that capital resources have not been put to their most effective use.

Why is it that the real appreciation did not translate into a current account deficit? The explanation is simple. Had Morocco grown at its 'natural' rate (substantially higher than 3 percent) import expansion would have overwhelmed export flows, leading to a substantial deterioration in the current account. In other words, the current account did not deteriorate simply because the economy did not grow as fast as it should have and could have done, given the rapid accumulation of both labor and capital resources.

What are the future challenges for exchange rate policies? Staff is perfectly right in pointing out the many challenges that Morocco's exchange rate policy will face in the near future. First, trade liberalization with the EU will lead both to a loss of tariff revenues and to an increase in import demands. Both factors will call for a more flexible management of the exchange rate. Second, given Morocco's high MFN tariff, the agreement with the EU could well lead to massive trade diversion. To prevent such an outcome from happening, Morocco will need to pursue a substantially more ambitious agenda of multilateral trade liberalization. On this count as well, therefore, the exchange rate will have to be managed in a more flexible way. Third, the phasing out of the Multifibre agreement in 2004 will open EU markets in textile and clothing products, which had been hitherto protected to the benefit of Moroccan producers as well, to the full competitive pressure of global competition. Moroccan producers will therefore face a substantial erosion in their competitive position in EU markets. To recover the loss of competitiveness, the exchange rate may well need to be adjusted. Last, but not least, Morocco is still highly vulnerable to both domestic (i.e., weather-related) and external shocks. A flexible management of the exchange rate is crucial both to cushion the impact of such shocks when they occur and to promote the expansion of non-traditional exports, which are in turn the key factor to promoting the diversification of the economy away from its traditional base and limiting vulnerability to shocks. On all counts, therefore, there are compelling reasons for Morocco to shift to a more flexible exchange rate policy.

Are there any compelling arguments against the shift to a more flexible exchange rate policy? The authorities' main concern is that such a policy may fuel inflation. However, lackluster growth in the face of mounting

social pressures could soon force a relaxation of the prudent macroeconomic stance followed so far, with a definite negative impact on inflation. The argument is also made that the exchange rate is an ineffective tool for promoting exports. This argument however should be put to rest, given the great amount of econometric evidence in this respect and, perhaps more pointedly, the substantial response of non-traditional exports first to the real depreciation in the second half of the eighties and then to the exchange rate appreciation in the nineties. Morocco's authorities also argue that an exchange rate realignment would weaken the private sector's incentive to improve productivity. However, there is no evidence, on the contrary, that an appreciated exchange rate has in any way contributed to faster productivity growth. A final area of concern emphasizes the possibly unfavorable social consequences of a flexible exchange rate policy. Again, there is compelling evidence – reported in a World Bank study – that Morocco's exports are highly labor-intensive, thereby providing valuable job opportunities for the poor as well. Similarly, remittances are also known to contribute to poverty reduction and to respond substantially to exchange variations. On both counts, therefore, a more flexible exchange rate policy aimed at reversing the real appreciation of the dirham and boosting exports and remittances would contribute to poverty reduction.

Morocco's authorities should be commended for their commitment to a prudent macroeconomic stance. Unfortunately, there are indications of mounting social pressures for a substantial fiscal expansion. According to staff, the annualized deficit in the second half of this year could well reach 7.5 percent. It is essential to stress that Morocco cannot jump-start the growth process through expansionary fiscal policies. The experience in the early eighties is telling. More crucially, fiscal equilibria hinge now on a delicate balance. It is true that the debt-to-GDP ratio fell during the nineties. However, this was due to a virtuous combination of adequate primary surpluses and low interest rates on domestic debt. If the primary surplus was to be turned into a deficit, the virtuous combination could wane and be replaced by a vicious circle of growing risk premia and growing debt stocks. The commitment to fiscal rectitude is essential if Morocco's growth promises are to be fulfilled.

To sum up, I agree with staff that Morocco faces a growth crisis. This is particularly surprising in light of the potential for fast and equitable growth of Morocco's economy. If Morocco is to achieve high and sustained growth, it would be essential for the authorities to persevere on their commitment to a prudent macroeconomic stance, to press ahead with an ambitious program of structural reforms, particularly in the traditional fields of price and trade liberalization, and to opt for a more flexible management of the exchange rate. With these remarks, I wish the authorities all the best in their future endeavors.

Mr. Shaalan submitted the following statement:

Morocco's economy has witnessed considerable improvements over the past few years. The steadfast implementation of adjustment measures was undertaken in tandem with far-reaching reforms in a number of areas. In addition to prudent monetary management, which has been reflected in a number of key macro indicators, the pace of structural reforms was accelerated. Among the key initiatives taken to promote an economic environment conducive to the growth of a robust private sector, was the passage of a new privatization law about a year ago. Additionally, legal and customs reforms, as well as new rules governing public procurement, were introduced. These reforms should provide a solid basis for future growth.

The ongoing reforms are taking place in an environment that has made the process more challenging. First, the increased frequency and severity of the droughts in the nineties rendered economic performance more volatile and difficult to forecast. This has, in turn, increased overall economic uncertainty. Furthermore, important changes to the political landscape are underway. The (former) opposition party has won in 1998 the premiership for the first time in forty years, and thus the new coalition government needs to seek broader support than in the past for new policy initiatives. While this has slowed down the implementation of some measures, it has opened the way for more solid support for the reform agenda.

A balanced assessment of economic policies, current and prospective, would need to take into account the constraints that may be dictated by the aforementioned political environment, and the consensus building and public support that are necessary ingredients for an effective implementation of a reform agenda. The staff appears to accord little importance to these considerations, arguing that the government's concerns with consensus building and avoiding social conflict has led to a slower pace of economic reform than is warranted by economic considerations. We are of the view that rallying support for the reform agenda both at the political and public levels should be accorded more important emphasis.

The generally encouraging economic and policy performance of Morocco in recent years notwithstanding, the staff identifies certain areas that need to be addressed so that the country can realize its growth potential. The policy recommendations are centered around the external sector, fiscal consolidation, and accelerated structural reforms.

The staff rightly points to the importance of ensuring a more competitive economic structure to promote the country's exports and growth. To this end they raise some concerns about the external sector. In addressing these concerns we are of the view that a clear distinction needs to be made between the level of exchange rate and the exchange system. On the first point

the staff argument for a depreciation which is based mainly on the less than robust export growth and CPI-based appreciation of the domestic currency is not altogether convincing. Here, it is to be noted that the current account deficit for the past five years has averaged less than 1 percent annually. Moreover, there are no evident pressures on reserves as these remain at a comfortable level. The less than robust export performance of recent years resulting in part from the severe and frequent droughts and weak mineral prices could have also been affected in the nineties by the slow growth in European economic activity, where the country's exports are concentrated. Notwithstanding these considerations, the staff argues that with higher growth in the economy, the current account would deteriorate. However, what we need to know is whether an increase in the current account deficit of some quantifiable magnitude would generate undue pressures on the external sector. In this connection, it is well to note that the staff projections for the average current account deficit over the next five years is less than 1 percent of GDP (Staff Report Table 7, p.45).

A forward-looking policy, as the country becomes increasingly exposed to global competitive factors, would call for a review of the exchange system with a view to rendering it more flexible. To be successful the introduction of a flexible exchange rate regime should be part of a comprehensive package centered around a tight financial policy framework including, in particular, a strengthening of the fiscal stance and continuing with the structural reforms particularly in the labor/civil service/wage areas. Without supporting policies the domestic currency would be subject to significant depreciation raising inflationary pressures that would make containing wage increases more difficult.

Fiscal policy has played an important role in stabilizing the economy, by maintaining the deficit at a low level through the various weather-related swings of the economy. Two notable accomplishments are worthy of mention. Total debt to GDP ratio has been brought down significantly thereby permitting more flexibility in fiscal management, and the clearing of domestic arrears over the past year contributing to the enhancement of private sector confidence. However, looking ahead we encourage the authorities to accord high priority to further fiscal consolidation. The proceeds from the anticipated privatization should in no way deter from this objective.

Three major areas merit the authorities' attention in the period ahead. To bolster revenues, we like the staff, encourage the authorities to subject the agricultural sector to taxation. As the staff points out, with the termination of the blanket exemption status at end-2000, this may well be a unique and opportune time to take this important step. We encourage the authorities to move in this direction and develop the necessary administrative machinery for tax collection from this sector. Overtime, this could be an important source of government revenues.

The fiscal consolidation effort must rely to an important degree on expenditure reduction. This is underscored by the fact that, at 22 percent of GDP, the revenue-to-GDP ratio, which excludes the agricultural sector, is quite high. Against this background, two areas on the expenditure side of the budget need to be addressed in the near term. The disposition of privatization proceeds and wage policy. On the former, we echo staff recommendations that these proceeds should be used more intensively to cover part of the costs of structural reforms, in particular civil service reforms, and to retire public debt. This type of use, while less spectacular than public investment, is likely to result in a strengthening of the fiscal stance. At 12 or 12 ½ percent of GDP the wage bill is high by developing country standards. Reducing the wage bill by 2 percentage points in the context of a civil service reform, which would also reduce the built-in wage drift, would be a major accomplishment for the period immediately ahead. Not only would it create room in the budget for needed social expenditure, but it would also reduce labor costs, rendering the economy more competitive.

Measures to address the issue of internal and external competitiveness of the economy clearly needs to focus on the structural area. Here the authorities have taken a large number of commendable steps of late, as listed in Box 1 of the main paper. The competition law, new labor code, modification of the rental laws, and the creation of incentives for private sector participation in new areas, such as transport and telecommunications, are particularly noteworthy.

In conclusion, while challenges facing the authorities to raise the sustainable growth rate of the economy remain, we are more optimistic than the staff regarding the economic outlook for Morocco. The authorities have set for themselves ambitious objective in the context of a medium-term plan to reduce unemployment and poverty. Staff argues that attaining the authorities' own objectives would require more ambitious policy measures than currently envisaged on the fiscal, structural, and exchange rate fronts. While the directions of the staff recommendations are for the most part appropriate, they need to be prioritized to take into account the circumstances of Morocco, and the dictates of the new political environment.

With these remarks, we wish the authorities continued success.

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

I would like to thank Mr. Faini for his statement. I must admit that I did not fully understand his surprise at what happened in Morocco in the 1980s and the 1990s. He claimed that the lower growth and employment was because the reform process was not sustained and because the exchange rate appreciated. Unfortunately, there is no clear evidence on either front. In

particular, there is no evidence that the exchange rate depreciation resulted in lower growth or low export growth. The World Bank report to which Mr. Faini is probably referring to indicates that agricultural growth reached 8 percent per annum during the 1980s, which was twice the average per annum growth of the entire economy. The report attributes this growth to favorable weather conditions, the reforms carried out by the authorities, and the agricultural sector adjustment program. While the weather conditions have deteriorated markedly in the 1990s as compared to the 1980s, there was no backsliding in earlier reforms. Rather, the pace of structural reform continues at a fast pace on several fronts.

Exports did not stagnate in the 1990s, despite an unfavorable regional environment. The strong performance of industrial exports under the temporary admission regime in the 1990s indicates that exports were not constrained by labor cost considerations, but by remaining impediments to investment, including administrative hurdles, scarcity of land, and other constraints that the authorities are trying to eliminate. The fact that export growth continued in the 1990s despite the appreciation in the currency indicates that structural reforms are working, but also that more time is needed before their full benefits can be reaped. The authorities therefore do not see the need to abandon the current nominal anchor and to change their exchange rate policy until the full benefits of the structural reforms are realized.

On fiscal policy, which was also addressed by Mr. Faini, I would like to refer to the staff assessment that the implementation of the 1999-2000 budget was satisfactory. Regarding the budget for the second half of 2000, the increase in the overall balance is explained mainly by the implementation of the program aimed at alleviating the effect of the drought, the increased investment permitted by the slack in the economy and the large privatization revenue, the effect of tariff dismantling in accordance with the Association Agreement with the European Union, the implementation of the first phase of the program of generalizing basic education, which accounted for most of the increase in hiring, and the extension to other departments on equity grounds of the promotion system which had been granted to the education and health Ministries in 1996.

The current declining trend in the debt-to-GDP ratio, the availability of nondebt creating resources, and the large slack in the economy do not pose major risks to stabilization despite the temporary increase in the fiscal deficit. Moreover, the authorities are firmly committed to maintaining fiscal discipline and strict selectivity of investment expenditures in terms of their contribution to growth, private investment, and social welfare. As indicated in the staff report, the selection of projects to be implemented through the Fonds Hassan II is to be based on their ability to attract additional private investment. It is expected that a positive supply response will bring the economy back to a more appropriate growth path. This would allow the

authorities more room for maneuver in addressing some of the remaining rigidities in the budget and for further fiscal consolidation. In any case, the authorities will continue to monitor the situation closely, and not rule out any option in case there is a need to reduce excessive demand.

I agree with Mr. Shaalan's statement, but I would like to make two points. First, any change in the exchange rate system should be well-sequenced with the fiscal consolidation and structural reform processes as well as the liberalization of the capital account. Second, experience with agricultural taxation in other countries demonstrates that this form of taxation will not result in increasing significant additional revenue, although it may be justified on efficiency and equity grounds.

Mr. Schlitzer noted that Mr. Faini had wanted to stress that he agreed with the staff that the appreciation of the exchange rate had played a role in influencing the economic performance of Morocco. Box 2 of the staff report clearly indicated that developments in the external area would have an impact on determining Morocco's rate of growth, while Box 3 mentioned that a further appreciation of the dirham would affect Morocco's export performance. Consequently, it was critical for Morocco to become a more open economy, and in this respect, a move to a different and more flexible exchange rate regime would be critical.

Mr. Daïri noted that the staff report treated Morocco as a small country that could rely only on exports to stimulate growth. He considered that this was not necessarily the case. Morocco could also stimulate growth through domestic demand and it did not seem appropriate to examine the issue of growth solely from an exports and exchange rate perspective.

Ms. Lissakers noted that many countries in the Middle East were plagued by low growth. However, one country that was experiencing higher growth was Israel. Elements common to the countries experiencing low growth were a fixed exchange rate regime and a lack of trade liberalization and deregulation. It was also amply evident that deregulation, trade liberalization, and flexible exchange rate regimes promoted growth. Israel was an example of a country that was experiencing higher growth ever since it changed its exchange rate regime. The other countries in the region should realize that trying to maintain the status quo or making only minor adjustments would not promote strong growth as the case of Morocco had proved.

Mr. Daïri remarked that in the case of Israel other factors contributed to its economic performance. It was important, however, for Morocco to pursue trade liberalization.

Mr. Al-Turki made the following statement:

Morocco has, unfortunately, been hit by consecutive devastating droughts during the 1999-2000 period. In view of Morocco's large agricultural sector, these droughts had a severe impact on growth performance

and greatly complicated the task of economic management. These unfavorable conditions notwithstanding, the authorities have continued their efforts at reform and adjustment. Indeed, Morocco's economic stability has been maintained with low inflation, a small current account deficit, and lower public debt. The fiscal target for 1999 is also broadly on track. Moreover, substantial progress has been made in the structural reform area as detailed in Box 1 of the staff report.

Much still needs to be done, however, in order to reduce vulnerability to exogenous shocks and place the economy on a sustainable high growth path. The attainment of these objectives hinges, to a large extent, on a strong investment effort by the private sector. In this connection, the increase in private investment flows over the past year is encouraging. The authorities should focus on strengthening the fiscal performance and rendering the domestic economic environment more conducive to private investment.

In the fiscal area, I am encouraged by the progress made in improving revenue collections and in modernizing the treasury's liquidity and debt management practices. In this regard, the ongoing decline in the debt ratio and the substitution of domestic debt for external debt should reduce vulnerability. The authorities' objective to cut the deficit substantially over the medium-term is also welcome. Achieving this goal, however, will be more demanding due to the envisaged widening of the deficit in the July-December 2000 period.

Against this background, I agree with the staff on the importance of reducing the wage bill through civil service reform. Reducing subsidies is also needed, not only to strengthen the budget but also to improve efficiency. While such measures will inevitably confront sizable opposition from various interest groups, especially given the drought and the high rate of unemployment at this time, the authorities should intensify their efforts to build the broad consensus needed to move ahead. In this regard, careful sequencing of the reforms so as not to induce higher unemployment and increase poverty is critical. Using privatization receipts to reduce debt and pay the costs of restructuring should also help strengthen the fiscal accounts over the medium-term.

On the revenue side, the authorities need to develop new measures to raise revenues in order to compensate for expected shortfalls resulting from trade liberalization. Reducing exemptions, simplifying the tax system, and strengthening tax administration are steps in the right direction. However, taxing agriculture and raising diesel fuel prices may be difficult at this time, given the impact of the drought on agriculture.

Turning to monetary and financial sector issues, I agree with the current stance of monetary policy. I also agree with the need for the central

bank to develop new market-based instruments to mop up liquidity. As for the banking sector, I welcome the ongoing efforts to recapitalize the housing bank. Here, it is essential to strengthen supervisory capacity and regulations, and conduct better credit assessments to ensure that the problems faced by this bank and the agricultural bank do not recur.

Strengthening growth performance would also require an accelerated pace of structural reform in other areas. In this connection, I join the staff in commending the authorities for the progress made in improving the climate for private sector activity. As Mr. Daïri notes in his helpful statement, "The revised privatization law and the reform of the telecommunications sector opened further the scope for private sector development." For the privatization drive to attain its full benefits, however, a more flexible labor market is needed. In this regard, I welcome the submission of a new labor law to parliament. Prompt action to enact this law should enhance productivity and competitiveness. The progress made in restructuring the education system also bodes well for the future. Further reforms are still needed, however, and staff suggestions in this regard are worth considering.

As for the external sector, the current exchange system has served the economy well. Therefore, I agree with Mr. Daïri that improving international competitiveness should focus on prudent macroeconomic policies and productivity gains. While the real effective exchange rate appreciated over the past few years, one has to note the shortcomings of this indicator. Other indicators of competitiveness also suffer shortcomings. Moreover, data on the volume of exports, tourism receipts, the current account position, interest rates, and reserves do not support the case for depreciation at this time. One has to keep in mind that a change in the exchange rate is not without risks.

Finally, I thank staff for their efforts and wish the authorities every success.

Mr. Barro Chambrier made the following statement:

The staff report on Morocco gives a mixed picture of recent developments. On the one hand, we are encouraged by the fact that macroeconomic stability has been maintained, inflation has remained low, and the external current account deficit is under control, with the level of international reserves rising to comfortable levels, despite an ongoing drought and declining terms of trade. On the other hand, we note with concern the declining trend in the rate of economic growth, the increase in the level of unemployment to high levels, and the widening of the underlying fiscal deficit.

The authorities are faced with challenging policy issues that should be addressed to ensure sustainable growth, lower unemployment, and a stronger

macroeconomic environment. In this context, we welcome their medium-term strategy which places appropriate emphasis on the need to promote savings and investment, maintain tight macroeconomic policies, and deepen structural reforms.

We welcome the recognition by the authorities that the fiscal accounts need to be improved and their focus on the need to reduce the wage bill. However, it appears that in the short term, the wage bill is likely to increase and that the measures envisaged will not reduce it below 12 percent of GDP over the medium term. In the event, we would encourage the authorities to consider a more comprehensive program of retrenchment together with adherence to a prudent wage policy, which appears to be necessary to achieve the fiscal targets set by the authorities. However, given the high level of unemployment and poverty, which appears to be increasing, reducing the size of the civil service at the present time may not be the appropriate course of action. Nevertheless, we encourage the authorities to consider a gradual retrenchment in the context of the medium-term development strategy.

We also agree that further efforts aimed at eliminating agricultural subsidies would contribute to the medium-term development strategy. The subsidy issue appears to be broader than simply a budgetary issue as the subsidies may be introducing serious distortions in agricultural production in favor of drought-sensitive crops. We understand the political and social sensitivity surrounding the subsidy issue and the importance of subsidized products for the poorer segment of the population. However, we agree it would help overall economic performance, and especially encourage the diversification of production to more drought resistant crops, if the subsidies were removed and replaced by other incentive programs. In this regard, we encourage the authorities to consider a more targeted assistance program together with a temporary system of income support for affected farmers.

In the same context of improving the fiscal accounts, attention should be given to the revenue side as well. Broadening the tax base and improving the tax yield have become more urgent because of the revenue shortfalls that have resulted owing to trade liberalization. It is therefore important that the authorities review their taxation system to make certain that the budget is adequately financed. In this context, we agree that the authorities should increase their efforts to ensure that all sectors are appropriately taxed. We also note that the tax exemption provided to the agricultural sector comes to an end this year and that the authorities will review the need for maintaining the taxation of this sector. As the majority of the farmers have large landholdings and agribusinesses which could be subject to a value-added tax and income tax, we encourage the authorities to consider these forms of taxation as they will contribute to improving the fiscal accounts. Moreover, the measures to counter the drought and social expenditures, place added pressure on the

budget which make it all the more urgent to implement revenue increasing measures.

We note that significant resources are expected from the privatization proceeds. While we welcome the intention of the authorities to devote these resources to public investment, we wonder whether this type of use is optimal. The public debt consumes a significant portion of budgetary resources and much of the other structural reforms needed in the agricultural sector and the civil service will be costly. The authorities may wish to reconsider the allocation of the privatization proceeds along the lines proposed by the staff to ensure maximum benefits.

Structural reforms are another area crucial to improving the growth performance of the Moroccan economy. Over the last three years the authorities have implemented a wide range of structural reforms, including an extensive program of privatization which has contributed to the removal of major rigidities in the functioning of the economy and to the strengthening of the private sector. Mr. Daïri's comprehensive statement and paragraph 36 of the staff report enumerates a long list of major reforms that have already been implemented particularly in the financial and banking sectors; in the judicial area and the legal framework; the introduction of codes of good practices and better transparency; and trade liberalization. Yet, in the past decade economic growth has been lower than in the previous two decades. Box two in the staff report shows that the real growth rate averaged only 2.4 percent in the nineties, 3.8 percent in the eighties, and 5.4 percent in the seventies. This is an alarming trend considering the economic reforms undertaken as well as the implementation of measures that have improved financial management. In fact, during the past decade, the primary balance has been in surplus and the government debt ratio has been on a declining trend. Moreover, both the investment and savings ratios have remained over 20 percent with the private sector accounting for the bulk of these ratios. While box two explains the consequences of a lower growth rate, it does not explain fully the causes behind it. It does not appear that the major reforms undertaken in the past decade have had a noticeable effect on the economy, which continues to be subjected to the wide swing in agricultural production, although the agricultural sector contributes to about 16 percent of GDP. Like Mr. Faini, we would like to know what went wrong in the nineties. However, unlike him we are not sure that the answer is in the lack of reforms which have been quite extensive. I thank Mr. Daïri for the explanation he provided at the beginning of our discussion, but perhaps the staff may want to make additional comments on this issue.

We are also surprised by the concluding sentence in box two which says that in a forward-looking sense, Morocco's tariff reductions, the elimination of textile quotas under the World Trade Organization, and the need for multilateral trade liberalization will further erode Morocco's

competitiveness. That implies that further trade reform may have an adverse impact on Morocco's performance, that the reforms so far have had no effect on the country's competitiveness, and that only the depreciation of the currency can help to restore competitive business. The staff's comments on these issues would be appreciated.

On the exchange rate issue, the staff's calculation showed that the dirham appreciated by 20 percent in effective terms since 1990. While we would agree that a more flexible exchange rate policy would be appropriate, we have to consider also that the depreciation will have adverse effects as well, and this may outweigh any gains under the present circumstances. Nevertheless, we would agree that, over the medium term, it would be helpful if the authorities were to follow an active exchange rate policy in support of a prudent macroeconomic policy and the extensive structural reforms that are already underway.

Mr. Junguito made the following statement:

We commend the Moroccan authorities for the progress made in macroeconomic stabilization despite the external shocks that have affected the country in the last years. Inflation has stabilized at a low level; the external current account deficit remains below one percent of GDP and the official reserves have increased to an equivalent of six months of imports. However, the rate of economic growth has not been enough to address the unemployment problem and to improve social indicators. We broadly agree with the authorities' medium-term strategy for accelerating growth as a precondition to reduce poverty and unemployment, but believe that further efforts in the fiscal and exchange rate fronts are also needed.

Fiscal consolidation will remain vital to achieve the expected rate of growth in the medium term. The draft for the second half of 2000 budget presented to Parliament envisages a significant widening of the fiscal deficit aimed at the support economic activity, and it raises concerns about the adequacy of the fiscal stance. Mr. Dairi has informed us that the widening of the deficit is transitory and that it does not raise issues in terms of longer-term fiscal sustainability. Further comments by Mr. Dairi on the subject would be welcome. We encourage the Moroccan authorities to continue with the structural reforms in the fiscal sector specially addressing the weaknesses pointed out in the Staff Report: the wage bill and the costly system of price subsidies. Once these distortions are corrected, the medium-term objective to increase government savings by five percent of GDP could be attained.

In spite of the improvements being made in monetary policy management, the difficulties found to mop up liquidity created by the privatization revenues suggest the need to introduce more market-based instruments at the central bank. The auctioning access to the central bank

deposit facility recommended by the staff can help to sterilize the monetary impact of external cash flows as well as to improve the market determination of interest rates.

The performance of the Moroccan banking sector, as reflected by asset quality, capital adequacy, earnings, and strength of management capabilities, is globally satisfactory. Nevertheless, we commend the authorities' efforts to strengthen the balance sheet of state banks as well as the process to privatize the last publicly-owned commercial bank. We encourage the authorities to proceed quickly in solving the capital adequacy problems presented in some banks and to closely monitor the loans portfolio in the system to avoid the increase of defaulted loans.

The issue of the exchange rate regime raised in the staff report and developed both in Mr. Faini's and Mr. Shaalan's statements deserves special consideration by the Moroccan authorities not so much given the significant real appreciation of the dirham during the nineties, but because of the need for exchange-rate flexibility given the expected worsening of the current account once economic growth is recovered and trade liberalization with EU advances. More important, the authorities should not be confident that the economic growth desired would be achieved only with the structural reforms underway since they alone may be insufficient in restoring the competitiveness of the economy.

Moreover, in the immediate term, under the current fixed exchange rate regime, care should be taken to prevent further real exchange rate appreciation due to the capital inflows and its impact on monetary expansion of privatization proceeds (i.e., using part of them to repay external debt obligations, as suggested by staff), and in establishing the minimum wage increase so as not to exert pressures on inflation. If the exchange rate regime were to be made flexible immediately, the tendency would be toward further appreciation of the currency. Staff comments on the subject would be welcome.

In terms of agricultural policy, Mr. Dairi's statement stresses the importance given by his authorities to rural development as one of the top priorities. Our experience indicates that the main tool for agricultural development is to have an appropriate exchange rate regime. As to sector-specific policies, we believe that addressing issues pointed out by Mr. Dairi, such as land ownership, research and extension, and access to credit are more important and less distortionary than costly trade restrictions and support prices.

As to the question of the need for taxation of agriculture, the issue is not clear-cut. The exemption of taxation of agriculture, together with the subsidies made would indicate the need for taxation. On the other hand, the

agricultural sector is probably being taxed through the tariff structure and effective protection of other (i.e., industrial) sectors of the economy. A study on the reality of effective taxation of agriculture would be welcome.

On the structural front, we commend the authorities for the progress made in judicial reform; improvement of the legal infrastructure for private sector activity; approval procedures for foreign investment; the measures taken to improve the transparency of the public administration; and the adoption of a new labor code.

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

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

Mr. Bauche made the following statement:

This very comprehensive Staff report, describes a very mixed situation. Indeed, in a medium-term perspective, macroeconomic performance for the last years has been marked by several improvements, for instance on the inflation front or in terms of external deficit. But we share the Staff's diagnosis that Morocco is facing a growth crisis, all the more worrisome as Morocco confronts rising unemployment, demographic pressures, and social challenges.

The staff suggests, and rightly so, a wide array of reforms with which we are generally in broad agreement, considering the pressing need to jump-start the Moroccan economy.

In particular, the staff's recommendations concerning increased public and private investment spending are well taken. In that vein, we welcome the measures taken by the authorities in the framework of the Hassan II Fund. However, the margin for maneuver for higher public investment is limited by the size of the wage bill, which, needless to say, calls for firmer determination from the authorities in the containment of the government wage bill. Furthermore, exceptional privatization revenues will not last forever and, against the background of declining revenues stemming from the disappearance of trade tariffs with the EU, the long-standing projected measures to raise the tax yield deserve the attention of the authorities.

As far as private investment is concerned, and notwithstanding recent progress achieved to enhance the country's attractiveness to foreign investors or to promote private sector development, much remains to be done. Immediate challenges in this regard include improvements in the labor market and the administrative environment.

Concerning the exchange-rate policy: even though the staff rightly recalls that structural handicaps of the Moroccan economy play a major role in impairing Morocco's competitiveness, it is hard to deny that a more flexible exchange rate policy could help promote better export performance. The arguments for and against an exchange rate realignment are very well presented in the staff paper; I would add that the impact on growth of a currency depreciation is somewhat unclear if that led for instance to increase the cost of the external debt and, as a consequence, to a possible crowding-out effect of public investment. More generally, the exchange rate policy is indeed not in itself the unique answer to Morocco's difficulties. Therefore, greater exchange rate flexibility could support Morocco's longer-term development, only when backed by a broad-based package of appropriate macroeconomic and structural policies.

With these comments, I wish the authorities all the best in their endeavors.

Mr. Mafarikwa made the following statement:

We commend the authorities for pursuing prudent macroeconomic policies, which have contributed to low inflation rates and low fiscal and current account deficits. Unfortunately, the country experienced recurring droughts in the past decade and as Mr. Daïri explained in his detailed statement, this largely explains the stagnation in economic growth. A total of five droughts during the 1990s have also contributed migration to urban areas, increase in unemployment and intensified the incidence of poverty.

The successful political transition has created the conducive environment for tackling many of the impediments to growth. Indeed, the authorities are wisely using their enhanced political credibility to garner social consensus that is critical to pursue reforms. In this context, the authorities are making encouraging progress in structural reforms, including the massive reforms in the education system that will, in the long-run, increase productivity and enhance job creation. At the same time, the professional handling of privatization in the telecommunication sector has improved efficiency and boosted international reserves and fiscal revenues. We encourage the authorities to persevere with these and other reforms that are critical to promoting private sector activity, fostering growth and reducing poverty. We also hope that the ongoing poverty assessment by the World Bank will help the authorities to further focus their efforts.

The cumulative effect of the droughts is putting pressure on government finances. We welcome that domestic arrears have been cleared and that public debt is declining. Nevertheless, it is clear that further efforts toward fiscal consolidation are needed, particularly in view of mounting expenditure pressures and the relatively large wage bill. I agree with

Mr. Shaalan that this is an area where the authorities could also make use of their privatization proceeds, reducing the size of the civil service.

It is encouraging that the external sector strengthened markedly during the 1990s. Debt-to-GDP ratio declined, the current account deficit is low, international reserves increased to record levels and export volumes are increasing. However, the economy is becoming increasingly exposed to global competitive forces, and this will impact the current management of the exchange rate. We encourage the authorities to deepen their structural reforms to further enhance the competitiveness of the economy. Also, the timing of fiscal consolidation will be critical in view of the pressures for tariff reduction.

We wish the authorities every success in their endeavors.

Mr. Wei made the following statement:

I would like to thank the staff for a well-written and candid report, and Mr. Dairi for his helpful and comprehensive buff statement. The Moroccan authorities have made consistent efforts in adjusting their economy and have made considerable progress over recent years which deserves our commendation. Morocco has been very unlucky in recent history, hit by serious droughts and other adverse economic shocks time and again, adding to the authorities' difficulties in the implementation of their reform agenda. However, despite this difficult environment, the authorities have continuously carried out their reforms, particularly in the structural areas. Their emphasis on social sector policy measures, including the enhancement of women's participation and contribution to economic and social development as well as education, are particularly welcome. Since I share the views of many of the previous speakers, I would like to make a few remarks for emphasis.

First, the authorities should be credited for their successful efforts in maintaining the internal and external stability of the economy, despite the difficult circumstances. Inflation has been kept low. There has been a strong recovery in private investment and the passage of a new privatization law will certainly be a stimulant. The current account is under control. External reserves have returned to comfortable levels. In addition, the authorities have continued to move forward with their structural reform agenda by improving the necessary legal environment for the reforms to take place.

However, the declining growth trend to 3 percent is alarming. I understand that the authorities have a five-year plan covering 2000-2004, to raise average annual growth to about 5 percent through continued structural reforms. However, facing the challenges of reducing unemployment and poverty, there is no room for the authorities to be complacent. I would

encourage them to take further measures to achieve a higher growth rate which will make it possible to create more employment and alleviate poverty.

I admire the authorities' commitment and determination in moving toward a more market-oriented economy. The reform of the telecommunications sector has been a great success. I am excited by the major education reform program that the authorities are launching. I also welcome their efforts and improvements in the dissemination of official statistics.

Second, on the issue of the exchange rate which was widely discussed last year, I share Mr. Shaalan's views in his statement. Generally speaking, the exchange-rate level has been appropriate if we examine a number of indicators, such as current account performance and the level of reserves. On the exchange regime, I share the authorities' view that financial stability must be given the highest consideration if there is a need to change the regime. The authorities are vigilant in monitoring external and exchange-rate developments, and they have the best judgment in making their exchange rate policies.

I share Mr. Shaalan's view that the political environment and social realities will need to be taken into account when the staff assesses economic policies and makes its policy recommendations. We believe that it will be very difficult for Morocco or any other developing country to implement economic reform measures without general political support and backing from the public.

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

The staff representative from the Middle Eastern Department made the following statement:

Several speakers raised the question of what went wrong in the 1990s. Actually, most things went well in the 1990s. Morocco entered a new era of price stabilization and solid macroeconomic management. Market mechanisms were disseminated into the economy, external debt was reduced, and trade liberalization occurred, maybe not as fast as the staff expected but, nevertheless, an Association Agreement with the European Union entered into effect in March 2000. There were also major structural reforms which are listed in Box 1 of the staff report. In addition, the financial system was modernized. The economy therefore has integrated to a large extent with the global economy and has modernized its structure, this has been done in an open environment with free debate and through consensus building.

The staff is in favor of the need to build consensus to the extent that it involves open debate and trying to convince people and various interest

groups. However, consensus building could also mean trying to satisfy everyone and there is a fine line to be drawn between taking decisions and prolonging debate. Any economic decision obviously will please some and disappoint others, but at some point such decisions have to be taken. In this respect, I should just mention that, for instance, on the subsidy issue, the debate has been occurring for the last decade and a decision has yet to be made.

Economic performance was disappointing in the 1990s because Morocco fell into a low-growth equilibrium. Mr. Shaalan is correct in pointing out that the external accounts are in balance and there is no looming crisis. However, the staff feels that there are three areas of risk for the external current account. The first is a deterioration in the terms of trade which is occurring because of the increase in oil prices. The second is a secular decline in remittances from workers as a proportion of GDP because the working population is aging. The third is the need for trade liberalization on a multilateral basis. In this respect, Mr. Shaalan has asked in his statement what would be the impact on the external current account if growth increased but the current exchange rate regime remained. The staff had employed the method developed, through the Coordinating Group on Exchange Rate issues and projects, a potential output growth of 6 percent over the next five years. However, if the present exchange-rate regime is maintained, the current account is projected to deteriorate by 4 percent of GDP. Such a scenario may not be unmanageable, but should be monitored closely in light of the risks mentioned earlier and the need to accelerate growth.

Mr. Barro Chambrier was a little bit perplexed by a sentence in the staff report regarding the impact of trade liberalization on growth. The staff recognizes that trade liberalization increases productivity, increases efficiency, and would be beneficial for Morocco. However, at the same time, it also makes imports cheaper and in that respect is equivalent to an appreciation of the exchange rate. Therefore, it puts pressure on the import substituting sector and it may result in some labor shedding in the short run, and harm competitiveness as well.

The relationship between structural reforms and growth is an interdependent one. There are some structural reforms that have an immediate positive impact on growth, although they can be difficult to quantify, such as improving the judicial system, liberalizing trade, providing land for industrial zones, and reducing the regulatory framework or at least simplifying it. However, some structural reforms are also stymied by low growth. For instance, civil service retrenchment is difficult to carry out when unemployment is at 23 percent. Similarly, the pursuit of trade liberalization may also result in labor-shedding, and a decline in tariff revenues, which would be difficult to carry out with high unemployment and budgetary pressures.

Finally, the authorities have told the staff that in the context of lower growth and the droughts it would be difficult to address the subsidy issue. This is yet another example of how low growth can delay reforms. Although, as Mr. Daïri said, domestic demand could be used as a means to stimulate growth, it will be difficult to follow this course if the agricultural sector remains stagnant. A moderate wage policy will also be necessary in order to maintain competitiveness, price stability, and avoid an appreciation of the real effective exchange rate. These elements make domestic demand a poor candidate for being an engine of growth given Morocco's particular circumstances.

Housing, however, could be an engine of growth, because it is labor-intensive and there is significant demand for it. But, on the whole, the staff does not feel that any increase in domestic demand can result in a doubling of the growth rate from 3 to 6 percent, and the World Bank shares this view. In a recent study on the sources of growth, the Bank concluded that the periods of high growth in Morocco's recent history have been associated with periods of high export expansion and that the correlation with domestic investment has been low. Indeed, domestic investment has had relatively high ICORs, and its direct contribution to GDP may have a direct demand stimulus. But, beyond that, it is not clear that there is a robust and positive relationship between investment and growth over the medium term.

Nevertheless, the staff is of the view that given the challenges that Morocco faces, namely to have a sustained rate of growth of 5-6 percent per year in order to generate 200,000 jobs a year, which it needs to do, all instruments have to be put into motion: tightening fiscal policy, accelerating structural reforms, and having a more proactive exchange rate policy that restores competitiveness and that does not allow the exchange rate to appreciate further.

Mr. Bauche raised the issue of the impact of a devaluation on the debt. Actually, the impact is more or less neutral, because the stock of domestic debt with respect to GDP (about 40 percent of GDP) would fall and the stock of external debt (36 percent of GDP) would rise proportionally to the devaluation. Indeed, the impact on the budget would be more or less neutral.

Mr. Daïri noted that domestic debt could also increase if the higher inflation stemming from the devaluation led to higher domestic interest rates. It seemed that the analysis contained in the staff report did not fully take account the effect a devaluation would have both on debt and on prices. Furthermore, a devaluation that led to an increase in inflation could also affect wage negotiations with labor unions.

The scenario mentioned earlier by the staff representative that projected the growth rate under both a fixed and flexible exchange rate regime should also be provided to the authorities so that they could analyze it, Mr. Daïri remarked.

Mr. Collins asked for further explanation as to how a devaluation would affect the stock of both public and external debt.

The staff representative from the Middle Eastern Department replied that the stock of domestic debt would decrease relative to GDP as a result of the increase in inflation that the devaluation would cause. The external debt would increase as interest rates increase to maintain their real levels, and debt-servicing would consequently increase. However, the real wage bill would decline and counterbalance some of the effects of the increase in the external debt, unless wages were also increased.

Mr. Yakusha made the following statement:

Let me thank the staff for their thorough and comprehensive report and Mr. Dairi for his helpful statement. The Moroccan economy has been affected in recent years by a number of adverse exogenous developments, including a severe and persistent drought and a slowdown in Europe (Morocco's main export market). The impact of the latter factor seem to be somewhat underestimated in the report.

The end-result of these shocks was increased unemployment, both measured and hidden, as well as some deterioration of poverty levels. The main challenge ahead is thus to reverse these negative developments, primarily by reinvigorating growth. Both the staff and the authorities seem to be in agreement on the elements of the strategy to attain this goal.

As regards the first element of the strategy, an increase in public investment requires a broader reorientation of government priorities within the context of public finances, to prevent an escalation of the already high level of the wage bill and external debt. Increasing public investment expenditure and its effectiveness thus may require the adoption of new revenue measures to replace losses associated with the dismantling of trade tariffs with the EU and lower dividend payments from partially privatized public enterprises [par. 29].

On the expenditure side, a comprehensive reallocation of spending is called for (also in light of the authorities' commitment to finance education restructuring and increase social spending over the medium run) - away from wages and salaries which currently absorb more than double the amount allocated on capital spending [Table 4].

On the issue of food subsidies, we think that the staff has, to some extent, overstated the issue, especially as regards the fiscal consequences. The issue is not so much how much support Morocco should provide to its

farmers, as the amount of assistance is rather small (0.8 percent of GDP), but rather what products Morocco should specialize in. In this regard, we share the staff's views that a liberalization of agricultural markets will provide local farmers incentives to produce those products which are both marketable and cost efficient. As regards interest expenditure, I note that this accounts for 20 percent of revenues in 2000 [Table 4]. Clearly, notwithstanding the fact that Morocco's external debt and debt service ratio have been on a downward trend in the past few years, they continue to remain at high levels, making a further effort on this front necessary.

As for the issue of competitiveness, the main area of contention in the staff report seems to be on the appropriateness of the current exchange rate policy. We do not question the fact that the fixed rates mentality has contributed to recent crises elsewhere. We also think that globalization requirements will sooner or later force the authorities to opt for greater flexibility. But immediate depreciation on its own may not be a comprehensive answer to the current problems of Morocco. The authorities may need to reconsider the whole policy mix and the exchange rate policy may be an element of that, but not the centerpiece.

In my view, the staff seems to exaggerate somewhat the weaknesses in the area of competitiveness which, it argues, are manifested in the form of weak export growth (compared with other developing countries), loss of export market share and an appreciation of the REER. I come to this conclusion for a number of reasons. First, the current account deficit is small. Second, export sluggishness may have been associated to a great extent with the slowdown in European markets. Third, the current account deficit may be structural in nature and may therefore call for structural reforms, rather than a depreciated exchange rate. Fourth, competitiveness concerns regarding the exports of goods are alleviated, to a large extent, by the strong performance of tourism [par. 5] during the same period, implying that competitiveness weaknesses are related to the nature of the exported products rather than the exchange rate. Fifth, the appreciation of the REER has been moderate in recent years when domestic inflation was put under control [par. 5].

Furthermore, it is also not clear to me whether a more flexible exchange rate may attain the intended results. In particular, I note that according to the staff the challenges facing Morocco's exports in the future, namely trade liberalization with the EU and a dismantling of textile quotas under WTO [par. 23], are structural in nature and will therefore require structural adjustments on behalf of Morocco. I also share the authorities' view that a depreciated REER may not lead to a substantial increase in agricultural exports to Europe, given institutional constraints (CAP) in the latter. We sympathize with the authorities' views that a depreciated REER may weaken the incentives of the private sector to modernize and improve productivity and competitiveness. I also wonder to what extent a depreciated exchange rate

may lead to inflationary pressures which the authorities, given their recent difficulties with monetary policy, may not be in a position to counter, thus adversely affecting competitiveness. More importantly, I have a question whether in the short run a more depreciated exchange rate would be safe for financial sector stability, given the potential difficulties that may arise in the banking sector (NPLs, undercapitalization of public banks). In light of this, I think the authorities should take all these factors into consideration when adopting changes to the exchange rate regime at this juncture, even though I welcome the staff's willingness to again raise this sensitive issue as part of the surveillance process. I am concerned, though, that such overblown importance was given to just one of the components of the policy mix.

Clearly, what is needed to reinvigorate growth and improve competitiveness is an acceleration of structural reforms. Morocco needs a technological upgrading of its production process to stay competitive and improve productivity. In the area of labor market reform, I encourage the authorities to proceed with plans to enhance labor market flexibility. I consider the rise of the minimum wage, in the presence of widespread unemployment, not to be the most optimal means of enhancing living standards for workers. Again, if the prevailing logic of social policy is to remain on the wage bill side, then no moderate depreciation will address the issue of competitiveness of labor costs.

Although the need to secure a social consensus when proceeding with structural reforms is understandable, without an acceleration of growth in the near future, the consequences on social tensions may be of increased proportions. This is something which the authorities may take into consideration when making decisions.

Mrs. Steinbuka made the following statement:

I am in general agreement with the thrust of the staff appraisal except for the exchange rate policy. The discussion on whether a more active exchange rate policy in Morocco would contribute to economic activity and to what extent this instrument would be adequate for enhancing competitiveness has a long track record. I recall that already in 1995 the staff recommended a more active use of the exchange rate policy. Since then, every year this issue was regularly brought to the Board and there was no unanimous advice. Some Directors advocated a more flexible exchange rate policy, whereas many other Directors supported the authorities' view that the fixed exchange rate has served the economy well and there was no clear need for changes. Our chair was in this latter group.

The question whether or not the exchange rate policy is appropriate for Morocco does not have any single answer today either. On balance, I would like to associate myself with those who have supported the existing exchange

rate regime. Without repeating a number of arguments, let me only caution against steps, which could erode confidence and impede maintaining macroeconomic stability now when inflation and current account deficit are low. Like Mr. Dairi, I do not see enough indications of misalignment of the exchange rate.

Instead of depreciation more emphasis should be put on the underlying policies, including liberalization and productivity enhancing structural reforms. Indeed, external competitiveness is presently constrained by a number of structural rigidities, which should be removed. This is not to say that the authorities should not consider moving to a more flexible exchange rate regime at the appropriate time. Has the right time already come? I am not convinced. Creating an environment, in which more flexible exchange rate system would be adequate, crucially hinges on strengthening fiscal policies, accelerating structural reforms and dismantling trade barriers. In this context, I welcome the authorities' close monitoring of increasing productivity and changes in competitiveness. Particularly, the impact of reduction of import tariffs from the EU on the external position should be analyzed. Besides, the predicted realignment of the world's major currencies in the years to come most likely will have an impact on Morocco's competitiveness and external sector.

With these remarks, I wish the authorities every success in the period ahead.

Mr. Collins made the following statement:

First of all, I would like to commend the staff report. I think the staff appraisal, in particular, should be a model for tactful but firm surveillance. While the authorities have attempted to advance policy in a consensual manner, which the scale of reforms to be implemented dictates as clearly sensible, there comes a point when tough decisions can be delayed no longer, and the staff representative explained that point tactfully in his remarks, and I fully share them. It is therefore disappointing that little substantial progress has been made over the last 12 months on a range of vital issues, most notably fiscal reform, civil service reform, and price liberalization. Fine-tuning budgetary policy or the speed of reform is ultimately less important than building political consensus to see a long-term strategy through in many areas and there has been ample debate and the need for reform appears well understood. As such, there appears little reason for delay, and the last 12 months have been particularly disappointing because much of the consensus building had already occurred by the time of the last Article IV consultation and yet there has been little follow-through to date. I cannot stress enough the economic cost of proceeding slowly. For example, the staff notes that price liberalization at present would have only a minimal impact on the agricultural sector, with world prices being close to the subsidized prices, but the impact

on incentives going forward would be dramatic with significant benefits for the economy.

Like the staff, I recognize that progress has been made in some areas in improving the legal framework for business in Morocco, by expanding the role of the private sector in a range of sectors, and generally reducing the amount of red tape that firms attempting to operate in Morocco have to encounter. Such reform is welcome but does not substitute for action in attacking underlying weaknesses in the fiscal position, nor the failure to address the need for civil service reform. In fact, increased hiring, the substantial wage rise, and the high number of promotions have, if anything, worsened rather than improved matters. I urge the authorities to heed the staff's warnings over inaction in that area.

The trade liberalization agreement [with the European Union will result in the dismantling of tariffs?]. It will therefore be essential that Morocco's competitiveness increase not only to reap the maximum benefit from improved access to the European Union, but also to ensure that domestic markets are not saturated with imports. As I said before, I find myself convinced by the arguments of Mr. Faini and others, as well as those of the staff, with regard to the exchange rate.

On fiscal policy, while the authorities have avoided using the proceeds of the Global System for Mobile Communication license to reduce the deficit, which is welcome, it remains disappointing that they have made little progress in tackling the underlying structural deficit, which is still deteriorating. Restructuring has to go further and deeper than currently envisaged. I would urge the authorities to adopt the staff's recommendations in this area. It is essential that future deficits be kept under tight control and, importantly, there not be any recourse to privatization receipts to reduce the deficit.

Ms. Vtyurina made the following statement:

I guess it is possible to tell if a country is in any type of crisis by examining its news briefs, and in the case of Morocco, I have found that the news mainly consists of reports about the soccer rivalry with France. Therefore, I would not go in the direction of proclaiming that Morocco is in the midst of a devastating growth crisis, like some of the Directors suggested. Instead, I would join those Directors who commended the Moroccan authorities for their continuing adherence to the implementation of market-based reforms and for achievements on the macroeconomic front, with the exemption of GDP growth. The latter, indeed, has been slow in recent years, but one should keep in mind that the country has been going through a major political transition on top of implementing structural reforms and coping with natural disasters. The country's growth pattern is an interesting and important topic to analyze; and today's discussion showed it. In this regard, I found the

description of the growth trend of the past decade in the RED as well as in Box 2 rather limited. The analysis conducted by the staff listed the changes of the underlying GDP factors, but fell short of examining the reasons behind these declines. At today's meeting Mr. Nashashibi presented a few very interesting points on his view of the growth patterns in Morocco and also mentioned a World Bank report; but it would have been very helpful to have had this information before the meeting.

The slower growth unfortunately has had a negative impact on poverty, illiteracy level and other social indicators. Improvements on the poverty front and education are not only essential for the well-being of the population but also for the resumption of growth and further integration of the country with the EU. In this regard, we welcome Mr. Dairi's comments on the authorities' actions and plans in this area.

I thank the staff for a well-written and comprehensive set of papers and now turn to comments on major areas of the economy.

The fiscal policy intentions, i.e. the widening of the deficit to over 7.5 percent in the second part of the year, fits rather with difficulty in the authorities' desire to achieve higher growth, cut the budget deficit and raise government investment over the next five years. Besides subsidies, a large part of the deficit is attributed to the wage bill increase, which, in turn, represents a continuous increase from 1997. On previous occasions we have cautioned that this type of wage policy is not only costly to the budget with its high contingent liabilities, but is also destructive to the rest of the economy because it limits spending on other important areas, such as public investment, education, and social development. Box 4 as well as last year's Article IV papers describe well the rigidities and limited effectiveness of the current civil service structure. The staff has made several useful suggestions on the ways to compress the wage bill to about 10 percent of GDP by 2004, however, it is regrettable that the authorities are hesitant in implementing these. While we strongly urge the authorities to reconsider their plans for further wage increases and redesign of the existing civil service structure, we do take into account Mr. Nashashibi's point that this reform will have to be carefully sequenced to take into account its effect on the already very high unemployment level.

In regards to tax issues there seems to be an obvious need to overhaul the existing tax system in various areas, including the elimination of export exemptions and improvement of the investment climate. We are glad to see that some of the recommendations of the FAD technical assistance mission of 1997 were taken into account in this year's budget, but clearly more reforms are warranted to increase the revenue flow. As to the taxation of the agriculture sector, there is also a need to have some sort of reform since the existing blanket guarantee is depriving the budget of much-needed revenues.

We agree with the staff that the integration into VAT and income tax system could be the first step in the reform. However, taking into consideration an interesting point made by Mr. Junguito on the tradeoff between subsidizing agriculture while at the same time taxing it, we believe that further examination of this issue is warranted. In this vein, we welcome the technical assistance that is requested by the authorities but wonder if this area has been covered by the 1997 mission?

On the structural reforms, we congratulate the authorities for the implemented reforms listed in para. 36 and in Box 1. These, indeed, are considerable achievements. But of course there is always room for further improvement, and in the case of Morocco most of the needed structural reforms relate directly to the improvement of the country's fiscal position. Therefore, we strongly support staff recommendations in para 38.

As usual, the debate about the exchange rate policy is very interesting. Both sides have rather convincing arguments, and are far from reaching a consensus. On the one hand, the staff states that potential high growth will widen the external gap at the current exchange rate, therefore a more depreciated exchange rate is warranted. On the other hand, there is an argument that exports are suppressed because of the appreciating currency and this, in turn, is hampering growth. It seems, however, that both growth and export are dependent on such a large array of factors, such as structural reforms, fiscal discipline, dependence on regional trade, weather factors, etc., that the exchange rate policy is not a main hurdle. In addition, at this stage, it is difficult to advocate greater flexibility of the exchange rate, because there are no clear signs of mounting pressures: inflation is low, reserves are increasing, exports continue to grow, and the current account deficit is below 1 percent of GDP. We do share one important point with the staff, and that is that a more flexible exchange rate policy if such is envisaged in the future, can by no means be a substitute for structural and fiscal reforms.

With this said, we wish the authorities further success.

Mrs. Fernández made the following statement:

On the outset, I would like to thank the staff for the comprehensive and well-written set of papers presented for today's discussion on Morocco. They certainly provide us with a clear view of the economy's main accomplishments and also with its most pressing challenges, notably, the achievement of a rapid but sustainable economic growth, capable to reduce unemployment and increase the living standards of the population.

The authorities deserve to be commended for their continued efforts towards implementing prudent macroeconomic policies, a commitment which has made possible to preserve, under difficult circumstances, the gains already

achieved in terms of internal and external stability. Unfortunately, however, since the last Article IV consultation the economic situation has deteriorated: drought conditions have come to further slowed down the output growth; competitiveness has worsened, as indicated by the loss of market shares and the continued appreciation of the real effective exchange rate; unemployment is on the rise; and the poverty rate is now close to 20 percent.

Against this background, and taking into consideration that this year's prospects still appear to be on the downward side, the authorities have adopted an ambitious economic program whose completion raises some questions, mainly on account of the fact that the current economic policies do not seem to go as far as it may be needed to render feasible the attainability of the program's objectives.

The arguments presented by the staff calling for a more ambitious set of economic policies are quite reasonable and its recommendations seem to be appropriate and well balanced: (i) to tackle the major sources of budget rigidity, notably the wage bill and food subsidies; (ii) to accelerate the structural reform of the economy; (iii) to consider the introduction of more flexibility in the exchange rate policy, so as to contribute to restore the most needed competitiveness; and (iv) the importance of increasing social spending.

Therefore, I associate myself with the staff and those colleagues that would urge the authorities to advance further the process of fiscal consolidation, centering the efforts on the reduction of current spending and notably the high wage bill.

With regards to the pros and cons of introducing more flexibility in the exchange rate, notwithstanding the fact that the exchange rate peg has served the economy well and taking due consideration of the concerns expressed by the authorities, particularly with regards to the inflationary pressures that could stem from such a measure, I tend to think it may be pertinent to render the exchange rate more flexible as the economy makes headway in its process of openness to the global economy. Moreover, being as it is the need to improve the economic activity a pressing objective, a more flexible exchange rate may allow the authorities to make use of an instrument that can certainly contribute to enhance competitiveness and growth. Needless to say, this flexibility should necessarily have to be accompanied by tight financial policies and a decisive structural reform agenda to avoid an undesirable depreciation of the exchange rate.

With regards to the structural reform agenda, it is certainly praiseworthy the progress that has been achieved by the authorities since early 1999. The reforms undertook in the judicial sector, in opening new sectors to the private initiative and towards increasing transparency in the

public administration, were all broad and well-focused steps to create an enhanced environment for private sector activity. Moreover, I am glad to note that these improvements have received an appropriate response from foreign investors as indicated by their interest in the privatization program. Indeed, the authorities' efforts to reach the necessary consensus on the major issues have certainly played a crucial role in these achievements. Nonetheless, there still remains much to be done. I welcome the high priority the authorities are giving to the strengthening of the financial sector. I encourage them to tackle without much further delay the reform of the civil service and engage on a broader process of price and trade liberalization.

Finally, let me welcome the poverty update being elaborated with the World Bank and that will draw an action plan for poverty reduction.

With these comments, I wish the authorities the best in their endeavors.

Mr. Keshava made the following statement:

At this stage of discussion I will submit my statement for the record. On the appropriate exchange rate policy, I would like to associate myself with the views expressed by Mr. Shaalan in his statement. I wish the authorities continued success.

Mr. Rigász made the following statement:

On the outset, I would like to thank the staff for the comprehensive and well-written set of papers presented for today's discussion on Morocco. They certainly provide us with a clear view of the economy's main accomplishments and also with its most pressing challenges, notably, the achievement of a rapid but sustainable economic growth, capable to reduce unemployment and increase the living standards of the population.

The authorities deserve to be commended for their continued efforts towards implementing prudent macroeconomic policies, a commitment which has made possible to preserve, under difficult circumstances, the gains already achieved in terms of internal and external stability. Unfortunately, however, since the last Article IV consultation the economic situation has deteriorated: drought conditions have come to further slowed down the output growth; competitiveness has worsened, as indicated by the loss of market shares and the continued appreciation of the real effective exchange rate; unemployment is on the rise; and the poverty rate is now close to 20 percent.

Against this background, and taking into consideration that this year's prospects still appear to be on the downward side, the authorities have adopted an ambitious economic program whose completion raises some questions,

mainly on account of the fact that the current economic policies do not seem to go as far as it may be needed to render feasible the attainability of the program's objectives.

The arguments presented by the staff calling for a more ambitious set of economic policies are quite reasonable and its recommendations seem to be appropriate and well balanced: (i) to tackle the major sources of budget rigidity, notably the wage bill and food subsidies; (ii) to accelerate the structural reform of the economy; (iii) to consider the introduction of more flexibility in the exchange rate policy, so as to contribute to restore the most needed competitiveness; and (iv) the importance of increasing social spending.

Therefore, I associate myself with the staff and those colleagues that would urge the authorities to advance further the process of fiscal consolidation, centering the efforts on the reduction of current spending and notably the high wage bill.

With regards to the pros and cons of introducing more flexibility in the exchange rate, notwithstanding the fact that the exchange rate peg has served the economy well and taking due consideration of the concerns expressed by the authorities, particularly with regards to the inflationary pressures that could stem from such a measure, I tend to think it may be pertinent to render the exchange rate more flexible as the economy makes headway in its process of openness to the global economy. Moreover, being as it is the need to improve the economic activity a pressing objective, a more flexible exchange rate may allow the authorities to make use of an instrument that can certainly contribute to enhance competitiveness and growth. Needless to say, this flexibility should necessarily have to be accompanied by tight financial policies and a decisive structural reform agenda to avoid an undesirable depreciation of the exchange rate.

With regards to the structural reform agenda, it is certainly praiseworthy the progress that has been achieved by the authorities since early 1999. The reforms undertaken in the judicial sector, in opening new sectors to the private initiative and towards increasing transparency in the public administration, were all broad and well-focused steps to create an enhanced environment for private sector activity. Moreover, I am glad to note that these improvements have received an appropriate response from foreign investors as indicated by their interest in the privatization program. Indeed, the authorities' efforts to reach the necessary consensus on the major issues have certainly played a crucial role in these achievements. Nonetheless, there still remains much to be done. I welcome the high priority the authorities are giving to the strengthening of the financial sector. I encourage them to tackle without much further delay the reform of the civil service and engage on a broader process of price and trade liberalization.

Finally, let me welcome the poverty update being elaborated with the World Bank and that will draw an action plan for poverty reduction.

With these comments, I wish the authorities the best in their endeavors.

The staff representative from the Middle Eastern Department made the following statement:

Mr. Yakusha raised the issue of the composition of public expenditures, and indeed, investment in Morocco has historically been quite low. On a national accounts definition, their capital formation is 3 percent of GDP, and this is why the staff actually welcomed the allocation of the Hasan II Fund to a number of investment projects and infrastructure because that is needed. But, at the same time rigidities in the budget and other areas have to be relaxed, particularly the wage bill.

Mrs. Steinbuka mentioned that investor confidence can be reduced if the exchange rate changes. However, it could also be increased by an exchange rate realignment, as such a course of action would increase competitiveness and therefore attract foreign investors.

Ms. Vtyurina asked why did the staff not discuss agricultural taxation during the 1997 Article IV consultation. The main reason was that there was a blanket exemption for the agricultural sector that had been given by the late King, and there was no point raising that issue at that time. However, as this exemption is about to expire, the staff raised the matter with the authorities during the Article IV discussions.

Mr. Yakusha asked what would be the likely impact on the financial sector if the dirham depreciated. The external vulnerability of the banking system was low. Furthermore, the movement of capital in and out of Morocco was not completely open.

Mr. Junguito asked whether a move to liberalize the capital account would result in an appreciation or depreciation of the dirham.

The staff representative from the Middle Eastern Department replied that it was not clear which way the exchange rate would move, although the staff expected the authorities to eventually move toward a managed float. As a result, a minimum level of reserves would have to be maintained and the real effective exchange rate would be prevented from appreciating, which would ultimately result in capital inflows. At the same time, it may stimulate capital outflows to the extent that rates of return abroad were higher.

Mr. Daïri made the following concluding statement:

I would like to thank Executive Directors for their useful comments and suggestions. I will convey them to my authorities.

In response to Mr. Junguito's question regarding the fiscal trend for 2001. I would like to indicate that the budget for the second half of 2000 cannot be easily compared to that of 1999. It would be better to judge the authorities' fiscal stance on a full-year basis.

A normal growth pattern is expected to return in 2001 which would bring higher revenue. Given that the elasticity of government revenue is relatively high by international standards, we would expect significant improvement in revenue if growth resumes as a result of a more normal agricultural crop and also because of the measures taken by the authorities over the second half of the 2000.

On investment behavior for 1999, the staff indicates that there has been an increase in investment, and they consider that this increase was the result of what they call lumpy investment in equipment imports, in power generation, and in transportation. I do not see the reason to exclude these vital components when we assess the overall trend in investment. On the contrary, we should give the authorities more credit as these investments will lead to increased investment in the future. Moreover, even if these so-called lumpy investments are excluded, imports of equipment goods increased in 1999 by 19 percent which is much higher than was observed in the past. Therefore, I am somewhat perplexed by the staff's assessment that it is uncertain whether this investment trend is going to continue, as there are no indications that it will not.

Finally, on the exchange rate policy, the authorities were also somewhat perplexed by the fact that despite all the explanations they had given and despite the previous Board discussions, the staff report was almost entirely based on the assumption that there will be serious negative consequences for Morocco if the exchange rate regime was not changed. The authorities are extremely troubled by this approach, and I think that it is not helpful to focus excessively on this one point, when other issues may be more important for long-term sustainable growth.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for maintaining macroeconomic stability through a period of recurrent severe droughts and international financial turmoil as well as changes in the political landscape. Noting that these factors made economic management all the more challenging, Directors welcomed the authorities' pursuit of prudent financial policies and steady structural reforms. They were

concerned, nevertheless, by the significant slowdown in growth observed during the 1990s, and the associated increases in poverty and unemployment.

Directors supported the policy objectives of the authorities' medium-term plan aimed at realizing the country's growth potential, notably the commitment to continue structural reforms and to reduce the fiscal deficit to a more sustainable level. They underscored the importance of restructuring the budget toward more productive expenditures and of accelerating structural reforms to ensure the steady increases in private investment and exports that will be needed to face future competitive pressures.

On fiscal policy, Directors noted the significant widening of the fiscal deficit in 2000. Several Directors also pointed to the structural deterioration in the deficit owing to a further increase in the wage bill. Against this background, Directors underscored the need for budgetary reforms. Of particular importance were measures to curb the wage drift and to reform the civil service. Such measures would generate the increase in government savings that is necessary for higher public investment and social outlays as well as for deficit reduction.

Directors also urged the authorities to take measures to expand the coverage of the tax system and to take concrete steps to phase out the generalized consumer food subsidies. In this connection, some Directors encouraged the authorities to liberalize prices in the agricultural sector and subject it to taxation. However, recognizing the difficult tax administration issues involved, they noted that the authorities should first seek to develop the necessary administrative machinery for this purpose, possibly with Fund technical assistance.

Directors did not expect the rising budgetary imbalance to have adverse macroeconomic effects in the short run, inasmuch as there is substantial slack in the economy and as proceeds from the sale of the Global System for Mobile Communication (GSM) license and privatization receipts would help finance the deficit. They noted that, under unchanged policies, financing problems were likely to emerge down the line in the face of declining tariff revenues and rising expenditure commitments and pressures. Directors therefore encouraged the authorities to use privatization receipts to reduce public debt further and to finance costly and politically sensitive structural reforms needed to ensure a durable reduction in the underlying deficit.

Directors congratulated the authorities on the significant achievements realized in modernizing the economy, citing the successes in judicial reform, improved efficiency in public administration, and greater scope for private sector activity through privatization, concessions, and demonopolization. They encouraged the authorities to continue with their reform program in

these areas. Directors noted that efforts on other fronts could be accelerated, in particular toward liberalizing the trade regime, adopting a revised labor code providing for greater labor market flexibility, simplifying and liberalizing the regulatory framework, and eliminating price distortions in agriculture that favor drought-sensitive crops.

Some Directors took note of the decline in competitiveness over the 1990s, and several Directors considered that, in conjunction with structural reforms and fiscal consolidation, a more flexible exchange rate policy could play an important role in strengthening competitiveness and spurring faster growth. They noted the added competitive pressures that will result from trade liberalization. Other Directors took the view that the current fixed exchange rate arrangement has served Morocco well and remained appropriate when viewed against the strength of external accounts and the need for preserving financial stability. Furthermore, productivity gains realized as structural reforms take hold would improve competitiveness.

Directors welcomed the improvements made in monetary policy management and financial modernization over the last few years, and commended the central bank for its role in preserving price stability.

Directors commended the authorities for the efforts employed to improve the dissemination and timeliness of statistical information, including through Internet websites. They noted that further efforts were needed to broaden the coverage of government finance statistics to include local governments.

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

3. CAMEROON—2000 ARTICLE IV CONSULTATION; POVERTY REDUCTION AND GROWTH FACILITY—THIRD ANNUAL ARRANGEMENT—REVIEW, AND EXTENSION OF COMMITMENT PERIOD; AND ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—PRELIMINARY ASSESSMENT OF ELIGIBILITY

The Executive Directors considered the staff report for the 2000 Article IV consultation with Cameroon and on the midterm review under the third annual arrangement under the Poverty Reduction and Growth Facility (PRGF), and its request for extension of commitment period (EBS/00/90, 5/23/00). They also had before them a paper, prepared jointly by the staffs of the Fund and the International Development Association, presenting a preliminary assessment of Cameroon's eligibility for assistance under the Initiative for Heavily Indebted Poor Countries (HIPC) (EBS/00/91, 5/23/00); a statistical appendix (SM/00/98, 5/23/00; the report on the observance of standards and codes (EBS/00/96, 6/1/00); and a paper on the financial system stability assessment for Cameroon (FO/DIS/00/66, 5/24/00).

The staff representative from the African Department submitted the following statement:

This statement provides information on recent economic developments in Cameroon since the circulation of the staff report for the 2000 Article IV consultation and midterm review under the third annual arrangement under the Poverty Reduction and Growth Facility (PRGF) (EBS/00/90).

The most recent data on economic activity and international trade are broadly consistent with the revised real GDP growth projection of 4.2 percent in 1999/2000. The slowdown in forestry sector activity following a partial ban on exports of logs is largely offset by buoyancy in the agriculture and construction sectors. The 12-month inflation, as measured by the national consumer price index, eased to 1.8 percent in March 2000 from 2.9 percent in December 1999. Monetary developments for the period March 1999-March 2000 point to a stronger-than-projected contribution by Cameroon to the net foreign assets position of the Bank of Central African States (BEAC) (CFAF 114 billion), benefiting from higher oil prices and a more favorable exchange rate, and better enforcement of export-earnings repatriation requirement, notably in the oil sector; at end-March 2000 Cameroon's position in the operations account with the French Treasury turned positive for the first time since 1988. Expansion in credit to the private sector (13.4 percent) was stronger-than-envisaged and growth in broad money (18.2 percent) was higher than anticipated, reflecting the increased confidence in the domestic banking system.

Overall program performance in the third quarter was mixed. Four quantitative benchmarks for end-March 2000—the floors on total budgetary revenue and the primary budget surplus and the ceilings on net bank credit to the central government and to the nonfinancial public sector—were missed owing to shortfalls in both oil and non-oil revenues totaling CFAF 19 billion (0.3 percent of GDP or 6 percent of total revenue for the quarter). The floor on the primary budget surplus was missed by the same amount; however, the ceilings on net credit to the central government and to the nonfinancial public sector were missed only by small margins amounting to CFAF 4 billion and CFAF 5 billion, respectively, owing to underspending on nonprimary expenditure.

The oil revenue shortfall of some CFAF 10 billion stemmed from the fact that the latest oil sales transactions for the quarter were delayed to end-March and the proceeds were transferred to the budget in April. The authorities stressed that the cumulative oil revenue target for 1999/2000 as a whole would be met. Regarding non-oil revenue, the shortfall of CFAF 9 billion was caused by continued weaknesses at customs. To strengthen the customs administration, the director of customs and the heads of the three most important customs offices at the Port of Douala have been

replaced and stricter controls to combat fraud have been put in place, as part of the action plan to reform customs.

In the oil sector, the harmonization of the accounts of the national oil company (SNH) with international standards (prior action) was finally completed in May with the assistance of an internationally reputable audit company. The new accounting system, together with a new computer system, which integrates SNH with the foreign oil companies, should enable the auditors to conclude a meaningful financial audit of SNH's accounts for 1999/2000 by mid-September 2000.

Regarding domestic arrears, the government continued to proceed with the validation process. The first stage carried out by an independent audit firm ended in mid-April 2000 with the validation of CFAF 130 billion of wage arrears out of CFAF 170 billion. A settlement plan was prepared, which is to start the next fiscal year and be completed over a 10-year period. The validation of the remaining domestic arrears (estimated at CFAF 97 billion), including the multiyear settlement plan, initially due for end-May, is now expected to be completed in mid-June 2000.

Implementation of structural reforms remains broadly on track. In the water sector, after several delays, the successful bidder for the privatization of the national water company (SNEC) has been selected in May (prior action) and negotiations are to begin shortly. In the telecommunications sector, the final round of bids for the privatization of the fixed telecommunications company (CAMTEL) was launched in May (structural benchmark).

In the education sector, the monopoly over the distribution of textbooks was eliminated and a textbook approval unit to define and publish a list of criteria for the selection of textbooks was established in April. With regard to the preparation of the interim PRSP, the participatory process was successfully conducted in early April in all ten provinces and the two major cities. A draft document is now under preparation and is expected to be ready in early July.

In the area of governance, the government appointed in late May the members of the Observatory for the Fight Against Corruption (Observatoire de Lutte contre la Corruption), which is to monitor the execution of the government actions in this area. The members of the observatory include representatives of the private sector, civil society, and NGOs.

In conclusion, the staff is concerned about the mixed performance during the third quarter and the missed financial benchmarks. The staff considers that the necessary policy adjustments have been made and that all end-June performance targets can be met; however, it urges the authorities to

exercise continued vigilance in these areas. With this note, the staff considers that the thrust of the staff appraisal remains appropriate.

Mr. Barro Chambrier submitted the following statement:

Since late 1996 my Cameroonian authorities have committed themselves to reverse the course of action by undertaking in the framework of the PRGF arrangement (1997–2000), IDA structural adjustment credit (SAC III) and adequate technical assistance, a wide range of economic reforms that is starting to bear fruits. It is to be noted that impressive progress has been made in macro-economic stability, public finances, relations with external creditors, restructuring the banking system, privatization, economic liberalization, transportation, and forestry sectors. Cognizant of the fragility of the situation and of the many important areas that remain to be addressed and in light of the board assessment during the last review the authorities are determined to address the so called second generation of reforms to reduce in a significant manner poverty, to improve governance particularly in the oil sector, so as to ensure the effective delivery of social services and the development of the basic infrastructure. This is going to require an appropriate sequencing of the reform agenda and the strengthening of policy implementation.

Consecutive to its good record of performance under the first two annual arrangements, Cameroon's achievement under the first half of the third annual arrangement continued to strengthen. During that period, progress continued with regard to fiscal sustainability, structural reforms, including a large-scale privatization of the parastatal sector, and liberalization of the energy and transport sectors.

Recent Economic Developments in 1999–2000

The increased resilience of the economy can be assessed in light of the sharp deterioration in the terms of trade experienced in the first half of 1998/99. However, these developments had an adverse impact in the real sector. Further to the downward revision of real growth output during the period 1998/99, weak performance of exports of non-oil commodities has led to a further scaling down of real GDP growth estimates for 1999/2000 to 4.2 percent compared to 4.8 percent in the program; nonetheless, growth remained strong. Progress realized on the inflation front continued to strengthen, with the 12-month national consumer price inflation declining to 1.8 percent compared with 2.9 percent during 1998/99. The widening of the external current account deficit (including grants) from 2¾ percent of GDP to 4½ percent in 1998/99 stemmed mainly from a weakening of both oil and non-oil exports relative to 1997/98.

Reflecting the slight deceleration in economic activity, monetary developments were characterized by a less rapid expansion of credit to the private sector, but also by a more than anticipated improvement in the net foreign assets position of the banking system. Thanks to the improved fiscal position of the government stemming from improvement in total revenue, the authorities were able to reduce their indebtedness vis-à-vis the banking system. Thus, net foreign assets of the central bank improved by CFAF 45 billion during the first half of 1999/2000. The competitiveness gains realized in the aftermath of the devaluation of the CFAF were broadly maintained with the real effective exchange rate declining by 3 percent from January to December 1999.

On the fiscal front, progress continued to be consolidated, thanks to the implementation of strong measures aimed at improving tax administration, collection and combating fraud. Although customs revenues were weaker than anticipated, non-oil revenue outcome was higher than envisaged reaching about 16 percent of non-oil GDP compared to about 14 percent of non-oil GDP in 1998/99, as a result of the progressive strengthening of tax administration and the smooth implementation of the value-added tax. Regarding oil revenue, with the firming up of world oil prices and the reinforcement of the monitoring and transfer mechanisms of SNH's oil proceeds to the budget, the overall contribution of the oil sector to the budget improved significantly over the targeted amount. The additional oil revenues is expected to be used to accommodate more social related expenditures and repayments of arrears, as indicated in Box 2 of the staff report.

With regard to structural reforms, the authorities are also continuing to consolidate the notable progress achieved during 1998/99. In particular, with regard SNH, a third annual financial audit building on the recommendations of the first two audits has been conducted, and the key recommendations pertaining to the first two annual audits regarding computerization and the adoption of international accounting standards to international norms have been implemented.

As a result of the measures implemented and described above, all quantitative and structural performance criteria set for the first half of the fiscal year 1999/2000 have been met. Similarly, all benchmarks (except the ceiling on bank credit to the non-financial public sector for a small margin) were also met during the third quarter. However, owing to technical delays in transferring some of the oil proceeds four quantitative benchmarks were missed at end-March 2000. However, for the year as a whole, the cumulative oil revenue will be met.

Based on the encouraging results achieved so far, the authorities' objectives over 1999–2002 seek to bring the economy into a sustainable

growth path, and reduce poverty over time. Focus will also be put on continuing to improve governance and accountability and on further implementing efficiency-enhancing structural reforms.

Program and Strategy for 2000–2002

Given these notable achievements in the context of Fund-supported programs and the need to tackle remaining impediments so as to enable more sustainable quality growth, my authorities would like to reiterate their commitment to pursue forcefully the implementation of the remaining leg of the third annual program under the PRGF, in order to reach the decision point under the enhanced HIPC around September 2000. In this context, they have updated the medium-term framework and have advanced in the preparatory work for defining a poverty reduction strategy, including the launching of a large participatory process. A preliminary HIPC document, outlining these policies and indicating the results of the DSA has been developed.

Despite some delays and unavoidable resistance to change vis-à-vis increasing transparency and the deepening of the democratic consultation process, my authorities remain determined to pursue this very demanding and difficult path.

Therefore, consistent with the medium-term objectives, it is projected that real GDP will increase to about 4 percent during the 1999/2000 program, to reflect the expected lower performance of non-oil exports. Inflation will be limited to 2 percent; and the external current account deficit contained to 3½ percent of GDP. Given the favorable outcome of projected oil prices, the external situation may improve further and could allow for a further narrowing of the external current account deficit.

Fiscal Policy

The medium-term fiscal policy will continue to focus on increasing public sector savings, expanding the non-oil tax base, widening further the primary balance, and reducing the overall fiscal deficit. The strengthening of non-oil revenue is directed at improving customs and tax administrations, combating fraud and enhancing forestry tax. The reform of the forestry sector will be realized, with the assistance of the World Bank, with the objectives of preserving the environment, and promoting the development of processing industries with high value added. The broadening of the tax base should also be by the strengthening of the value-added tax (VAT) collection, namely by extending the responsibilities and coverage of the large-taxpayer unit to all taxes, and speeding up transfers of VAT collected by public enterprises, before their full privatization. At the same time, all export taxes have been eliminated except those on forestry products. To improve customs revenues, the authorities intend also to set in this context a single formality window at

the Port of Douala by July 2000. These measures should help raise non-oil revenue from 13.5 percent of GDP in 1999/2000 to about 15 percent of GDP in 2001/2002. Thus, total revenue would increase to about 19 percent of GDP. Overall, a primary surplus of 7.1 percent of GDP (5.2 percent of GDP in the original program) would be attained and remains high at an average of 6 percent of GDP over 2000/2002, while the overall fiscal position excluding grants, would be close to balance at 0.3 percent of GDP (relative to 2.9 percent of GDP in the original program), well below the 1998/99 outcomes.

With regard to expenditure, the original target of maintaining the level of total expenditures to about 19 percent will be realized, entailing a civil service reform to enhance incentives and performance, a further reduction of the size of the civil service through the privatization of a number of government services, and modernization of the remaining civil service, and to better management and monitoring of government outlays. The higher primary surplus, along with improved expenditure management and governance, will support through better allocation, the government's planned increase of expenditure on social services (education and health) and the rehabilitation of physical infrastructure.

The authorities are envisaging a number of measures aimed at improving public expenditure management. These include reinforcement of the audit function of the Ministry of Finance and the external audit agencies; and they are improving transparency and governance issues through the continuation audit of the procurement system and the establishment of expenditure control procedures for a number of public entities and special Funds. In addition, the reports on the execution and delivery of quality basic services of the budget of two key ministries have been extended to eight others.

Monetary and Credit Policies

Monetary policy in Cameroon will continue to be conducted at the regional level by the BEAC, consistent with the general principles set at the regional level, targeting balance of payments and inflation objectives. In this framework, the authorities will play an active role in consolidating the use of indirect monetary policy instruments and contribute to the strengthening of the common pool of reserves. In light of the strong fiscal performance and the higher than expected oil prices, the program for the second leg of 1999/2000 aims at enabling Cameroon to contribute a further increase in the net foreign assets position of the regional central bank, the BEAC, while reducing net bank credit to the government. Credit to the private sector is projected to increase by about 10 percent. Broad money is expected to increase slightly in 1999/2000 relative to 1998/99 with the gradual buildup of confidence in the

domestic banking system as indicated by the results of the recently conducted FSAP and, more generally, in the reform program.

Structural Reforms

The structural components of the program will focus on consolidating and deepening the ongoing reforms in agro-industry, public utilities, petroleum, transport, and financial sectors. These reforms are essential for creating a favorable environment for private sector activity and for safeguarding Cameroon's external competitiveness. In the agro-industrial enterprise sector, a successful bidder for the conclusion of the sale of the palm oil company (SOCAPALM) was recently validated. The second phase of bids for the privatization of the Cameroon Development Corporation (CDC) scheduled for end-December 1999, has been delayed because of the complexity of the process and pending the definition of privatization strategy for its assets. In the electricity sector the selection of the successful bidder of the Electricity Company, SONEL, will be launched before end-November 2000, after the launching of the call for bids expected in June 2000. In the transport sector measures entailing the strengthening of the Road Fund, an action plan for restructuring the Port of Douala to reduce delays for international trade operations, and the continuation of the rehabilitation project for the newly created railroad company (CAMRAIL) are underway.

In the petroleum sector, a strategy defining the respective role of the national oil company (SNH) and the private sector in the production and distribution of oil and petroleum products to provide the basis for further deepening of the reform and liberalization of the sector is being defined with the assistance of the World Bank. Finally, in the context of regional integration and development of wider synergy, the authorities will speed up their efforts to complete the Chad-Cameroon pipeline, with the reconstitution of the consortium and the consideration by the World Bank board of the financing of its component of the project.

As for the reform of the financial sector, the authorities will pursue the disengagement from the banking network, as evidenced by the privatization of BICEC in January 2000, and by encouraging the development of a domestic financial market, reforming the social security system in preparation for its possible privatization, and the completion of the privatization process in the insurance sector, with the expected privatization of SOCAR (insurance) and the liquidation of CNR (reinsurance).

In the context of better transparency and governance, the authorities have agreed to participate in the FSAP round that was conducted during the period January–March 2000. The main conclusions of the FSAP indicate that although there are still vulnerabilities attached to some banks, the overall situation of the banking system was sound and profitable, with a low level of

nonperforming loans and high provisions. Work underway to strengthen the legal system should help consolidate the results achieved so far since the major launching of the banking sector reform.

In addition, the authorities will work in a concerted effort with other member countries to strengthen the regional banking commission (COBAC) and enhance its independence, including reinforcement of its surveillance capacity, recruitment and training of qualified staff in its supervisory unit. Equally, as an active member of the CEMAC, Cameroon will continue to participate actively in a number of initiatives aimed at accelerating the economic and financial integration, including the implementation of trade reforms that will entail the elimination of remaining import surcharges by end-June 2000 and further reductions in the common external tariff to a maximum of 20 percent, in line with the west African zone countries (WAEMU).

As an indication of their commitment to achieve their ambitious program, my Cameroonian authorities are putting governance and transparency issues at the center of their reform strategy, particularly with regard to the public finances, the privatization process and the fight against corruption. In this regard, they are taking a number of initiatives such as the audit of key public enterprises, the procurement system, the road fund and the forestry sector concessions. Most importantly, they intend to adopt the National Governance Program developed with the assistance of the World Bank and the UNDP will help curtail corruption and increase transparency.

External Sector Policies and Balance of Payments Outlook

The external current account is expected to improve over 1999/00–2001–02, declining from a deficit of 4.3 percent of GDP in 1998/99 to 2.7 percent of GDP in 1999/2000 (less than the 3.2 percent of GDP projected). My authorities hope that on the basis of the updated DSA, Cameroon will reach soon its decision point in the context of the enhanced HIPC Initiative, in order to ensure better targeting and improved efficiency of delivery of the expected resources in the priority areas of health, education, and poverty alleviation. The authorities also intend to pursue a debt and debt-service reduction (DDSR) agreement with London Club creditors, as well as various nonbank creditors, on terms equivalent to those reached with the Paris Club.

Preliminary HIPC and Social Policies

Based on the preliminary results of the DSA prepared by the authorities with the assistance of the staff of the Fund and the World Bank, and the successful completion of almost all the data reconciliation, the debt burden of Cameroon continues to be high, which is detrimental to the improvement of social indicators, notwithstanding tangible efforts made

during the past years. Estimates based on the debt data reconciled at end-1999 indicate that with a NPV to GDP of 53 percent, to exports of 214 percent and to revenues of 344 percent, Cameroon is eligible to assistance under the HIPC, and that the export criteria should be used to calculate the potential debt assistance and delivery. My authorities hope that with the headway made in terms of a constant and durable program implementation under the SAC III and the third and final year of the PRGF, the decision point under the HIPC will be set before end-September 2000. This would allow Cameroon to benefit potentially from an assistance of about US\$1.5 billion in NPV terms, that my authorities intend to allocate to priority social sectors.

Accordingly, they are in the process of preparing an articulated poverty reduction strategy on the basis of the already existing National Poverty Reduction Plan that will lead to the design of an interim PRSP to be finalized and presented with the final HIPC document to the World Bank and IMF boards at the time of the decision point. In this context, the authorities main social policy elements will aim at extending the benefits of the gains achieved during and beyond the program period to a large group of beneficiaries, in order to improve the economic welfare of the population. This will help reduce the scope of poverty through job creation, better education and health and improved infrastructure network, in the context of good governance and transparency.

Already, concrete actions towards social sectors are contemplated in the current PRGF. Cameroon's policies in the social area, in general, and in poverty alleviation in particular, will be based on the continuation of adjustment policies that will foster higher economic growth combined with targeted improvements in primary health and education, and access to safe water. Specific actions will target access to teaching material in the education sector and address the two leading causes of mortality (malaria and HIV-AIDS) among the population. In addition, investment in road maintenance and the measures to reduce transport costs will help improve the situation of the rural sector.

Technical Assistance and Data Issues

It is worth noting that the progress achieved so far has been permitted by the technical assistance extended by the Fund on the VAT, customs and expenditure management. Progress has been made in improving Cameroon's database, but the authorities will continue to need important technical assistance in a number of areas, and to improve their quality and coverage of data. Technical assistance for the definition of a set of quality social indicators, in preparation for their possible eligibility under the HIPC Initiative will also be needed. Moreover, my authorities consider the GDDS as a useful tool for statistical improvement, and are participating as a pilot country in the metadata and the reports of observance of standards and codes

(ROSC) for which major efforts to achieve compliance with the various principles set forth have already been made as indicated in the recent updated ROSC report.

Finally, I would like to reiterate the strong commitment of my Cameroonian authorities to the adjustment process. They remained determined to achieving successfully the current PRGF-supported program and set the track record for eligibility under the HIPC. In this context, I am requesting the support of the Board for the proposed decision. I wish also to add that the Cameroonian authorities, as in the past, have agreed to publish their Memorandum on Economic and Financial Policies on the external IMF website.

Extending his remarks, Mr. Barro Chambrier informed the Board that his authorities had agreed to the publication of their LOI, as well as their ROSC, and that they were taking strong action on governance issues.

Mr. Morais submitted the following statement:

Economic reform in Cameroon over the past few years has been both wide ranging and, by and large, successful. Growth has been strong; inflation has remained low; the fiscal situation has improved; and external competitiveness has strengthened. Equally important is what seems to be a clear message coming from the authorities that they have turned a new leaf on economic management—the staff note that this is the longest running Fund-supported program—and that they are also committed to enhancing their economic strategy by focusing more closely on poverty reduction. This message should be embraced by the international community as the cornerstone for strengthening economic relations with Cameroon—one that supports program ownership on the part of the country as well as provides the requisite financial resources and technical assistance to help the authorities realize their goal of improving the quality of life for the people of Cameroon.

Institutional reform has made a major contribution to the success of the program, and the fact that it remains a central focus strikes an optimistic note for the sustainability of the new direction of economic policy. In this connection, emphasis should be placed on those aspects of the program that are geared towards making public administration more transparent, that seek to develop processes for more effective delivery of social services, and that streamline the government's role in the economy and enhance its ability to improve the environment for promoting the private sector. These are building blocks for a stronger economy as well as for mounting a frontal attack on poverty.

There is no doubt that the program is ambitious, and while it calls for perseverance on the part of the authorities, there needs to be room for

flexibility in how we assess performance. The country faces significant capacity constraints and I wonder the extent to which this has been taken into account. It would be helpful if the staff would shed some light on this issue, as it is one of the risks to a successful outcome of the program. We have tended to argue that the issue of capacity constraint in the poorer countries should be addressed in the context of an explicit medium-term technical assistance program, bringing together expertise from the Fund, the World Bank and other institutions. The staff might wish to comment on whether this would be a suitable approach for Cameroon. The other issue has to do with the expected costs to the government of meeting the requirements of developing a poverty reduction strategy and monitoring progress. It is important to know the extent to which this is being incorporated into the fiscal scenario.

We welcome the information provided by the staff that the participatory process for the preparation of the interim PRSP has been successfully conducted and that a draft document is expected to be ready in July. This should help the authorities to move quickly to a decision point in the context of the HIPC Initiative. The report on the preparation of the paper in Appendix 5, however, raises some concern. For instance, the staff mention that 'the aim of the Bank-Fund mission was to provide a frame of reference on how to engage, sponsor, and eventually institutionalize the preparation of the poverty reduction strategy', which might raise questions as to who is in the driver's seat on the matter of PRSP. We need to be careful not to project our own biases in the process to the point where we might want to pass definite judgment, as the staff have done. In the present case, the staff conclude that the overall process was 'definitely credible and acceptable.' Definitely credible and acceptable to whom?

While on the poverty reduction strategy, we welcome the continued emphasis on growth. However, it is important to achieve higher growth well beyond what has been achieved in recent years to make a significant dent in poverty. The program has to also look into ways of increasing employment, considering the high rate of growth of the working age population, which is even higher than the 2.9 population growth. Perhaps, the staff could comment on the growth and employment prospects over the medium term.

Efforts aimed at strengthening the fiscal situation will remain crucial to stable economic development in Cameroon, and we would encourage the authorities to improve tax administration and reinforce steps to combat fraud. We agree with the authorities' intention to use additional oil revenue to increase social expenditures and reduce arrears. The question arises, however, as to whether the high primary surplus is not unduly restrictive, given the urgency of upgrading the country's social indicators. One wonders, also, why the level of capital spending is expected to be lower for 1999/2000.

Cameroon is a clear example of a country where the debt burden is unsustainable and a major impediment to the government's ability to fight poverty. Even after the Paris Club rescheduling, debt service paid has been about one-third of total government revenues for the past five years. Also, actual debt service has been substantially larger than social expenditures: for instance, 391.2 percent of social expenditures in 1997/98 and 173.7 percent in 1998/99. In terms of cash outlays, payments for the past five years totaled US\$ 2.382 billion, a significant amount considering the level of poverty in the country. It cannot be overemphasized that debt relief under the HIPC Initiative has the potential to make a significant contribution to alleviating poverty in Cameroon. In this connection, we support debt relief during the interim period between the decision and completion points. We also share the authorities' view that the success of their efforts will depend not only on debt relief, but also on the international community providing additional concessional resources.

To sum up, we believe that the authorities are on the right path and support the extension of the commitment period of the program.

Mr. Pickford and Mr. Kelmanson submitted the following statement:

We are grateful to staff for having pulled together such extensive papers and welcome the opportunity to comment, in the round, on issues ranging from ROSCs to HIPC.

Turning first to the Article IV report and PRGF. We welcome the progress made by Cameroon in addressing the economic problems faced by the country. Steady economic performance, supported by the windfall of higher oil prices, has helped compensate for a worsening terms of trade shift caused by declining prices for other primary export commodities. However, despite progress challenges remain, particularly the continued fragility of the external payments situation. This fragility highlights the need for diversification of the export base, the narrowness of which is emphasized by the fact that 72% of export revenue is generated from primary products (oil, lumber, cocoa and coffee). This export structure has remained static in volume terms since 1994/5 with fluctuations in export revenue being a function of world price changes.

Last year's Article IV discussion identified the need for diversification of the non oil export sector as a necessary counterpart to stimulating private sector development in Cameroon and putting the external accounts on a sustainable basis. Four key areas were identified as needing to be addressed: access to credit, legal and regulatory obstacles; trade and tax system and physical infrastructure and some progress has clearly been made in these areas (notably in the financial sector). We would welcome staff views on whether there are signs of any positive economic impact from these reforms.

The Article IV document is a very thorough piece of work however, in some areas we felt that the description of program measures lacked a sense of discrimination between the various structural actions and their likely economic impact and importance.

For example, the liberalization of the monopoly in the supply of textbooks (as part of a wider education sector strategy) is considered a structural benchmark. It seems from the associated footnote that this is primarily aimed at improving governance – this will have a positive impact on the effectiveness of education spending, but it is not clear what the economic impact will be. How important do staff consider this to be in economic terms, and how does it rank in importance relative to other structural criteria?

We also sense some lack of consistency between the detailed prescription in this document over the uses of public expenditure and the claim by other Fund missions that this is the job of the World Bank. There may be good reasons for different approaches, but we would welcome staff comments on this issue.

Participation in the FSSA and ROSC pilot projects is to be strongly commended and we would welcome views on how much of this information is likely to be made public. The FSSA and the ROSC both highlight areas where progress has been made, and they also allow the authorities to identify areas where further work is needed and where Technical Assistance can play a role. All outputs are to be welcomed.

One consistent theme throughout the report, with which we would agree, is the low level of institutional and administrative capacity. Clearly this presents a tension. On the one hand should limited resources be used for these pilots, on the other hand participation can allow countries to identify areas for action to improve economic potential. Does Mr. Barro Chambrier, or staff have views?

Moving onto the Preliminary HIPC Document, we welcome the assessment and look forward to considering a Decision Point later this year. The document helpfully sets out the assistance that Cameroon would be eligible to receive. However, it would have been helpful to have a table setting out debt service paid before and after HIPC (1 and 2) in order to assess (on a consistent basis) the additional resources freed up for poverty reduction.

Central to poverty reduction will be the effectiveness of spending and central to this is good governance. Efforts to date on poverty reduction have been poor, with a marked deterioration in social services, and the document rightly notes the importance of making progress here. We would like to have seen perhaps greater emphasis on this issue in the paper and will want to see

progress in these areas before Decision Point. Mechanisms for ensuring HIPC resources are directed at poverty reduction should be assessed on a case by case basis, but in this case a Poverty Action Fund (PAF) could be appropriate as long as it is integrated with the government's general budget procedures and plans.

Box 9 sets out the areas in which progress will be needed before Cameroon can reach Decision Point. However, some of the DP targets seem ambitious unless actions are already underway, for example in the area of HIV/ AIDS. We would welcome views from staff on how achievable these targets are.

On the conditions set out for Completion Point we feel that they seem to vary significantly between items which are rather broad (and require a subjective assessment e.g. anti-corruption strategy is satisfactorily implemented) and those which are much more specific and objective (e.g. promulgation of new law on private teaching). At this stage, we feel a sensible approach would be to have broad aims, with key indicators and milestones being identified in a participatory way during the development of the PRSP and at the time of Decision Point.

On timing, we feel that an interim PRSP is achievable by September. But we wonder if the indicative timetable of a full PRSP mid-2001 is achievable, given that it is only 9 months away. A comprehensive PRSP, developed in a participatory way, and linked to an MTEF, will take time to prepare and we would urge the authorities not to rush this, especially given that they should be receiving interim relief. In addition, given the limited progress on poverty reduction in the past, we believe that a start on effective implementation of the PRSP before Completion Point is appropriate.

Mr. Milleron made the following statement:

At the outset, let me say that I am rather impressed by the large number of reports on Cameroon before us today, and I commend the Staff for the considerable work they have accomplished in order to provide the Board with a comprehensive analysis of the economic and financial situation of this country. The general feeling that emerges from these documents is that Cameroon is moving forward. There is still a hard journey to make, but it is well underway.

Regarding the report for the 2000 Article IV Consultation and on the Midterm Review of the PRGF, I broadly agree with the Staff's appraisal which is frank and well balanced. On the one hand, Cameroon's good track record these last years under the PRGF is clearly presented and fully acknowledged, both in macroeconomic performance and structural reform implementation. On the other hand, Staff rightly emphasize the challenges

ahead for Cameroon, notably in their statement, which contains the most recent information. I share the view that, despite substantial achievements, the gains made over the past few years need to be consolidated and there are still many weaknesses to be addressed. For instance, in the budgetary area, the authorities must remain vigilant and pursue their efforts to meet all end-June performance targets and to strengthen expenditure management.

Another important aspect of Cameroon's performance is related to transparency and governance issues, on which I am pleased to note that the authorities have been taking courageous and decisive actions. This is encouraging and they should continue vigorously. In this respect, let me underscore a particular component of governance on which the Cameroonian authorities must devote strong attention, namely the judiciary framework and its functioning process. This point is currently a key factor explaining the country's negative perception among donors and investors. Without any significant improvement, the difficulties encountered in the functioning of the judiciary system could become a major impediment in many essential parts of the economy, including in the banking sector, as appropriately raised by Staff in their Financial System Stability Assessment paper.

With these comments, I can approve the proposed decision on the PRGF and will now turn briefly to the HIPC preliminary document. Overall, I can go along with the approach proposed by Staff on the decision and completion points. Of course, the debt data contained in the report are still provisional and the reconciliation process has yet to be completed. As usual in this area, I expect Staff to be very attentive to the burden sharing among creditors, notably regarding the agreement to be concluded with the London Club creditors, who have to make a comparable effort as the one envisaged by the Paris Club in the framework of the enhanced HIPC Initiative. Finally, I note that Cameroon has well undertaken the process which will lead to the PRSP and I encourage the authorities to continue on this path with determination.

Ms. Redifer made the following statement:

The staff documents aptly notes that the public at large remains very skeptical about Cameroon's performance, despite this review marking 'the longest stretch of adherence to a Fund-supported program.' This chair falls in that camp but supports completion of this review and extension of the commitment period. We agree with the requirements laid out in Box 9 of the preliminary HIPC document as conditions for reaching the decision point for HIPC. The key issue in assessing whether Cameroon should be deemed eligible for HIPC assistance will be whether the authorities demonstrate their firm commitment to the most efficient use of existing and new resources for the objectives of macroeconomic stability, growth and poverty reduction,

thorough credible progress on a set of key issues outlined below. From our perspective, the jury is still out on that question.

Preliminary HIPC Review

In our view, the staffs of the Fund and Bank have recommended concrete, focused, and meaningful prior actions for the decision point, as outlined in Box 9. Our support for a decision point will be unambiguously linked to the fulfillment of both the letter and spirit of these prior actions. However, we are doubtful that these actions can be accomplished in a timeframe for a decision point in September, based on the overall track record on structural reform. As the CAS progress report going to World Bank Board on June 15 notes, Cameroon has made 'little progress in key areas of structural reform, notably public expenditure quality and management and reallocating budgetary resources to priority social sectors.

We particularly agree with the basic focus on governance and anticorruption, and key measures in health and education. Box 3 has an extensive list of milestones that are to be accomplished in governance in the medium term. We would emphasize first and foremost a focus on fiscal expenditure management and monitoring. Similarly, mechanisms for ensuring accountability for expenditures are crucial. The new monitoring mechanism for tracking SNH revenues to the Treasury is one indication of nascent progress. Over the long term, consideration of the use of a poverty action fund with a built in monitoring mechanism to ensure productive use of the potentially large amount of freed up resources from debt relief may be an advisable approach, but the application of monitoring mechanisms will need to cover the entire budget envelope. We will also be carefully watching the fulfillment of conditionality under the recently approved Bank structural adjustment loan for civil service reform.

We would also expect to see progress on a composition of spending more prioritized to productive development objectives. Perhaps staff or Mr. Barro Chambrier can clarify why military expenditures have risen so dramatically in recent years (30 percent since 1994-95). The proportion of spending on military versus those on health and education is alarming for a country that has had the recent deterioration in living standards that Cameroon has had over the past fifteen years. With the HIV infection rate so high, a public health crisis looms that could seriously impair Cameroon's growth strategy. We implore the authorities to think seriously about how spending can be reprogrammed away from the military to more productive uses, such as health and education, or, as the authorities point out, as they also face huge domestic debt burden, retiring domestic debt. My authorities will be watching the issue of military expenditures in the future very carefully.

Similarly, we urge the authorities to maintain funding for the forestry management plans that have been introduced with Bank support, as well as the critical measures to mitigate the environmental risks associated with the Chad-Cameroon pipeline.

We agree that Cameroon meets the criteria for consideration of debt relief, and we do not have any objection to the proposed amount to be delivered according to the preliminary debt sustainability analysis, but note that it is a sizable sum. If we come to a decision point in September, again which we see as unlikely, we can go along with using end-June 1999 data, and we would support the provision of interim debt relief. We strongly agree that the authorities need to stipulate how the effective use and monitoring of savings from interim debt relief should be used. In fact, this should be incorporated into the interim PRSP, and should be considered a standard feature of these documents, to the extent feasible.

The proposed actions for the completion point also provide a helpful initial reference. We will be providing more specific suggestions at the decision point and once a complete action plan on governance is available. In fact, the Board documents indicate that a strategy and action plan on governance and corruption would be finished by June 2000. Perhaps staff can give the Board an update on where that stands. In the meantime, we have a few concerns on the participatory process. First, we are concerned that there needs to be an explicit mechanism for bilateral donors to participate in development of the PRSP. Second, we are worried that the participatory process, as described in Annex III, is still not fully 'owned' by the authorities. We will need to be satisfied at the decision point that a fully credible participatory process is well mapped out.

PRGF Review and FSSA

We agree with the staff appraisal that the authorities should reap the benefits of higher oil prices and privatization proceeds to begin a process of fiscal consolidation, including clearing domestic arrears. This, of course, must be tempered against the dramatic needs for additional spending in the social sector, some portion of which can be met by reprogramming resources from the existing fiscal envelope. We agree that the most pressing structural measures to be addressed are public expenditure management, transparency and accountability, governance and corruption, and a determined effort to 'finish the job' on privatization. We join the staff in encouraging the adoption of recommendations on computerization and use of international accounting standards for the SNH, and look forward to the operational and managerial audit, as well as a defined strategy on the role of the state versus the private sector in the production and distribution of oil.

We encourage the Fund staff, to the extent possible, to be open to discussion on macroeconomic adjustment strategies that arise throughout the PRSP process. As the new comprehensive framework for lending evolves, we will expect to see clarity in the PRGF documents on how a more participatory approach may have affected the pace, sequencing and content of reforms the Fund staff ultimately agrees upon with the authorities.

The FSSA was well done. We would like to stress the staff's conclusions that a weak judicial system brings about high intermediation costs, and that a more sophisticated banking and payments system would bring about a more efficient system with smaller overhead that could better service a broader swath of the population, including more small and medium enterprises. In fact, it is encouraging to see that Cameroon is considering participating in the creation of a regional financial market. To improve COBAC's (Central African Banking Commission) supervisory and regulatory capabilities, investments should be made in training, formalizing risk management systems and increasing the frequency of on site examinations. We encourage Cameroon to raise capital adequacy standards, as the current low ratio does not factor in significant operational risk. Finally, can staff comment on how Cameroon will incorporate microfinance clients into the mainstream banking sector?

Mr. Sakr made the following statement:

We are glad to note that Cameroon's persistent and successful reform efforts over the last few years have helped bring about a satisfactory economic performance. Commendable progress has been accomplished, particularly in the fiscal and governance areas. While it is regrettable that program performance in the third quarter was mixed, it is reassuring that necessary policy adjustments have been made and that staff considers that all end-June performance targets can be met. Mr. Barro Chambrier's informative preliminary statement also confirms the authorities' intention to continue to pursue strong reform measures. We, therefore, support the completion of the review and the extension of the commitment period. We would also like to congratulate the authorities, and the staff, for achieving the longest stretch of adherence to a Fund-supported program with Cameroon.

It is important to note, however, that the reform agenda is far from complete. Continued efforts are still needed in order to consolidate recent progress, especially in view of the still large debt burden and widespread poverty. I shall therefore, Mr. Chairman, focus in the remainder of my statement on fiscal and some governance issues in key economic areas that have an impact on the macro variables, as well as on the issue of external competitiveness.

The authorities are to be commended on their fiscal efforts which, despite certain slippages, led to a steady increase in non-oil revenue in percent of GDP over the last three years. It is, however, essential to keep the reform momentum and consolidate progress achieved thus far. In particular, it is important to reform the customs department, continue to improve tax administration, broaden the tax base, and enhance the process of transferring VAT receipts to the national treasury. Furthermore, the authorities should continue their efforts to adhere to spending priorities, reform the procurement system, and improve the transparency of the fiscal and spending processes in general. Adherence to the fiscal reform program will help release resources for social outlays, particularly in health and education. However, it is important to note that it takes more than increased outlays to ensure improved effectiveness in these sectors.

Governance should automatically benefit from the above fiscal reform measures, particularly those related to the customs department and public procurement. It is, however, crucial that the authorities give this area utmost attention. It is disturbing that, in addition to the customs department, the two sectors that suffer most from bad governance are health and education. These two sectors are most important to the poor and to sustaining and developing human capital. While we welcome the recent work to expose major weaknesses and design reform strategies in these sectors, we join staff in urging the authorities to take fast and concrete actions. In this regard, we welcome the recent measures to fight corruption as explained in the staff statement and in Mr. Barro Chambrier's preliminary statement such as the abolition of the monopoly of textbooks, the replacement of the director of the customs department and the stricter controls to combat fraud in that department, and the establishment of various bodies to monitor and fight corruption.

Moving to external sector issues, we join Mr. Pickford and Mr. Kelmanson in their concern about the fragility of the external position. Despite the depreciation of the CFA franc against the dollar, the projections of non-oil exports and of imports for 1999/2000 are now significantly worse in real terms than the original program projections. As a result, what staff consider a stronger than programmed current account position, is in fact worse than programmed should we abstract from the effect of the increased oil prices. Could staff comment on this as well as on the factors behind the deterioration in the non-oil trade account and the implications for external sustainability?

The staff report states that the authorities are to continue to enforce the repatriation requirement of exports receipts to help improve Cameroon's contribution to the net foreign assets of the regional central bank (BEAC). Do we take this statement as an endorsement of the repatriation requirement? And if so, what is the rationale behind this endorsement?

As regards the issues for discussion in the HIPC paper, we agree that Cameroon qualifies for assistance under the enhanced HIPC Initiative as recommended by the staff, and we are hopeful that the country reaches the decision point in September. We also agree that Cameroon should receive interim assistance.

Finally, we wish the authorities continued success in their endeavors.

Mr. Vittas made the following statement:

Let me first commend the authorities for the improved policy record that Cameroon has displayed during the third annual PRGF arrangement. During that period, the authorities have demonstrated a strengthened commitment to establishing a sound basis for sustained growth and poverty reduction in the future.

Notwithstanding recent progress, however, Cameroon is still confronted with difficult challenges, especially in the area of governance. Moreover, the country has some way to go to dispel negative perceptions within the international donor community. It will thus be crucial for the authorities to sustain and reinforce their reform efforts in the forthcoming period.

In view of those challenges, it is somewhat worrisome that a few of the quantitative benchmarks for end-March 2000 were missed. The nonobservance of those benchmarks raises some doubt as to whether the new mechanism for assuring the timely transfer of revenues to the budget is operating in a fully satisfactory manner. It also points to continued weaknesses in customs administration. I did note, however, that both the authorities and the staff are confident that those policy slippages will be corrected during the remainder of the year.

In light of governance problems, it is heartening to see that the authorities have agreed to participate in the FSAP and ROSC pilot projects. The reports emerging from those initiatives will contribute importantly to identifying problem areas, including weaknesses that need to be addressed urgently.

With regard to the preliminary HIPC document, the initial assessment of Cameroon's debt relief, and the issues for discussion, I agree that Cameroon should qualify for assistance under the enhanced HIPC Initiative, and should receive interim assistance. Whether a decision point around September 2000 is feasible or not will depend on policy implementation in the period ahead. This chair would not object to using end-June 1999 debt data if no other data is available at the time when the decision point is reached. As regards the conditions to be met prior to the completion point, Box 9 in the staff paper provides some useful pointers. However, I would have a preference for the approach suggested by Messrs. Pickford and Kelmanson, namely setting broad aims at present with specific targets to be decided during the development of the PRSP and at the decision point.

I am pleased to support the proposed decision and wish the authorities continued success in the future.

Mr. Alosaimi made the following statement:

I am encouraged by Cameroon's improved record of adherence to policies agreed with the Fund. While the mixed performance in the third quarter is a concern, I welcome the assurance in Mr. Barro-Chambrier's statement that the authorities are determined to implement the rest of the current PRGF program forcefully.

That said, like Mr. Morais, I have concerns over the extent to which capacity constraints have affected Cameroon's performance under the program. The burden of developing and monitoring a PRGF can be too heavy for countries to shoulder alone. Indeed, staff highlights the risks that the program faces in that regard and urges that the implementation capacity be reinforced. Program success in such a context may require provisions for well-focused technical assistance.

The importance of determined implementation is also evident on the structural reform front. The difficulties inherent in the ongoing enterprise restructuring and privatization effort are detailed in Mr. Barro-Chambrier's helpful statement. On the financial system, the progress that has been already made is reflected in the overall favorable judgment under the FSAP exercise. Let me stress here that the entire structural reform effort hinges critically on successful implementation of the steps to strengthen the economy's legal and regulatory framework.

On the enhanced HIPC Initiative, graduation to a sustainable debt status is clearly an unavoidable need for viable poverty reduction and growth in Cameroon. I also note the authorities' commitment to allocate debt relief to priority social sectors. In these circumstances, I agree that Cameroon is eligible for assistance under the enhanced HIPC as proposed. I also agree that Cameroon should receive interim assistance between the decision and completion points.

Given a continued record of satisfactory program implementation, I support setting of the decision point by September 2000. Staff's suggested possible use of end-June 1999 data in that context also has my support. While I also agree in principle to tying the completion point to policies presented in Box 9, it will be important for the Fund to be flexible in implementation in the light of the country's specific circumstances.

With these remarks, I wish the authorities success.

Mr. Schollmeier made the following statement:

Since we go along with staff's recommendations, I will be very brief. I will focus my comments on some central aspects:

Firstly, we are concerned about insufficient transparency in Cameroon. It is a widespread, serious problem. Therefore, it will be of great importance to enhance transparency and fight corruption. Tackling governance issues should be given highest priority to improve Cameroon's 'standing' in the international donor community. This is also crucial for participation in the enhanced HIPC Initiative.

Secondly, fiscal performance appears to be better than originally expected. However, this favorable outcome is mainly based on higher revenues from the oil sector and privatization proceeds. Since these fiscal revenues may reverse quickly, we strongly encourage sustainable improvements of fiscal procedures on both sides of the budget. With regard to the built-in contingency mechanism for the adjustment of quantitative benchmarks and performance criteria (in para. 32 on page 61), we are not sure whether this mechanism might endanger program conditionality beyond the underlying oil price developments. Staff comments are welcome.

Thirdly, the Financial Systems Stability Assessment (FSSA) provides a comprehensive analysis of the financial sector. Despite progress in bank restructuring, there remains a significant degree of vulnerability, resulting from low capital bases and fundamental liquidity risks. Like other speakers, we too, strongly encourage the authorities to reform the legal environment and strengthen the regulatory framework, especially with regard to banking supervision.

Finally, to the PRSP-process: it is encouraging to find that the consultations have already started in ten provinces and two major cities. The authorities should move ahead as quickly as possible and in close cooperation with the donor community to prepare a comprehensive, high quality Interim PRSP to fight poverty. It is our understanding that the challenge will be budgeting and implementation of poverty-reduction measures rather than outlining the strategy. We would like to stress the importance of 'ownership' and a broad-based participatory process. It should be possible to reach the decision point in September 2000.

With these remarks, we support the proposed decision.

Mr. Mirakhor made the following statement:

I join Mr. Milleron and other Directors in thanking the staff for the high quality of the FSSA, ROSC, and the staff reports. I also thank Mr. Barro

Chambrier for his comprehensive and helpful statement. The authorities should be commended for their steadfast implementation of the program, the prudent and steady economic performance, and for their acceptance to participate in the FSSA and ROSC exercises despite the strain on the limited administrative capacity. I concur with the thrust of the staff report on Article IV consultation and agree with the staff's appraisal. I also agree that the authorities' challenge at this juncture is to consolidate the gains made thus far, and to push forward with their reform agenda, particularly in the governance area. Here, I support Mr. Milleron's comments regarding the judicial reform.

I shall limit my remarks to two issues: the FSSA report and the preliminary document on the enhanced HIPC. On FSSA, I have two comments: first, the authorities should be encouraged to take full advantage of the many recommendations of the report on restructuring the financial sector and reducing its vulnerability. Second, it is clear that in the medium term the small- and medium-sized enterprises will have to become effective vehicles for much of the economic development and growth process. However, the FSSA report refers to a 'financial service void' for this vital economic sector. Reference is also made to a dual structure of the financial system, comprising the four largest banks and one branch of a foreign bank, accounting for 83 percent of all banking assets, but serving only a select clientele. On the other hand, there are some 700 savings and loan cooperatives and a large number of informal institutions that service the rest of the economy.

Under this financial structure, lending to the private sector is only 7 percent of GDP, compared to 23 percent in sub-Saharan Africa. So there is a real problem that has to be addressed immediately. In Section III of the FSSA report, however, the staff proposes a number of recommendations for developing the financial sector and improving financial intermediation, most of which are appropriate for the medium and long terms. Could the staff address the issue of how the problem of 'financial service void' for the small- and medium-sized sector could be addressed under the current PRGF agreement?

Turning to the preliminary document on enhanced HIPC, I welcome the debt sustainability analysis assessment and look forward to the Board's consideration under the decision point, hopefully before the Annual Meetings. There is no doubt that Cameroon is eligible for assistance under the HIPC and for provision of interim assistance.

Like Mr. Pickford and Mr. Kelmanson, as well as Mr. Alosaimi, I believe that the targets for decision point are ambitious and excessively detailed. I counted a total of 25 in Boxes 3, 4, 5, in addition to HIV actions detailed in paragraph 51. I wonder if there is adequate administrative and

technical capacity to implement, or at least make satisfactory progress in these programs by the time of the decision point.

I share Mr. Morais's and Mr. Alosaimi's concerns on the implication on the budget of developing a poverty reduction strategy and monitoring progress in these programs.

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

Mr. Cippa made the following statement:

I agree with most of the remarks made by Ms. Redifer. I can support the completion of the review and the proposed decision related to the enhanced HIPC Initiative. I can agree with the September 2000 decision point if the governance and anti-corruption measures are implemented as envisaged, if the PRGF is successfully completed, and an interim PRSP is prepared.

On completion point and conditionality, I support the policies presented in Box 9 of the preliminary document. However, I wonder whether under the PRGF, upfront measures in the area of governance and somewhat more ambitious fiscal adjustment would be feasible. Finally, I support the decision that Cameroon qualifies for the Initiative and is eligible for interim assistance between the decision and completion points.

That being said, I will focus my remarks on three points: governance, nonconcessional borrowing, and safeguards on the Chad-Cameroon oil pipeline loan.

On governance, I share the staff's concern about the country's mixed performance under the PRGF. Underperformance in the area of customs revenues demonstrates once more the importance of addressing governance issues. Achieving progress in that area will be also essential for the credibility of the enhanced HIPC Initiative, and to assure that the debt relief provided under the Initiative will be used effectively for poverty reduction programs. I was worried by the staff's assessment regarding the widening and deepening of corruption, which is now a major obstacle to private investment and has led to a significant deterioration in social services. I would urge the authorities to ensure that oil revenues are transferred to the treasury in a transparent manner, and that the national oil company adopts international accounting standards. On the expenditure side, as the staff, I consider that there is an urgent need to enhance the efficiency and transparency of budgetary management. The low level of expenditures on education, health, and basic infrastructure results in low performance in the area of poverty reduction. I am deeply worried about the fact that most education and health indicators have deteriorated in recent years and are worse than in comparable African countries. Therefore, it is important not only to quickly develop strategies for those sectors, but also to swiftly implement them. I also

encourage the authorities to reverse last year's sizable increase in military expenditures.

My second point is on concessional borrowing. I would like to know how the concessional loan the World Bank granted yesterday to Cameroon squares with the enhanced HIPC Initiative. I am uneasy with the signal we are conveying to the international community that the Bretton Woods institutions are, on the one hand, granting debt relief and, on the other hand, extending nonconcessional loans to a HIPC country. I would appreciate some comments from the staff and maybe also from the World Bank representative.

My third point is on safeguards on the oil pipeline loan. The need to safeguard the revenues generated by the pipeline seems to have been extensively discussed in the case of Chad. However, Cameroon also faces governance problems. In that respect, I would like to know what are the built-in assurances that will prevent any misuse of the transit fees Cameroon stands to receive from the pipeline.

Mr. Fenton made the following statement:

I would like to thank staff for the impressive documentation for today's meeting, including the supplementary materials on the FSSA and ROSC.

I shall begin with the Article IV report and the PRGF. As staff note, in past discussions of Cameroon, Executive Directors stressed the importance of strengthening policy implementation capacity, and the need to take decisive and visible actions to improve transparency. I am pleased to see that there has been progress in these areas, particularly with respect to bringing oil revenues automatically and transparently into the budget and bringing SNH into conformity with international accounting norms. Nevertheless, much remains to be done in these areas.

I shall have some specific comments on policy requirements later in my remarks, but at this point, I would like to note that we agree broadly with the focus of the revised program for the second half of the year and would underline, in particular, the importance of adopting a comprehensive governance strategy and proceeding vigorously to tackle issues of governance as a core component of the reform agenda. We also think that the FSSA provides a valuable service in identifying a program for improving the financial sector and support the measures proposed by staff, especially the strengthening of the legal and judiciary framework.

Turning to the Preliminary HIPC Document, Canada would like to see Cameroon reach its decision and completion points in a timely manner. Having said this, it is also important to ensure that a quality poverty reduction

program is in place to properly allocate these resources to key priorities such as health and education for children and women.

Given its checkered reform record and its dismal ranking at the bottom of Transparency International's 1999 Corruption Perception Index of 99 countries, it is necessary to closely monitor and assess the government's commitment to enhance and advance the reform agenda, particularly in the areas of governance and poverty reduction. In this context, the government's decision to take specific actions prior to the decision point to improve governance, to address the HIV/AIDS issue and to improve service delivery to the poor is a welcome sign of political will and commitment to the reform process. The Government should complete its strategies for the health and education sectors in a timely manner and should adopt a comprehensive strategy to improve governance and reduce corruption to reach the decision point. We agree with Mr. Pickford and Mr. Kelmanson that a Poverty Action Fund could be appropriate for Cameroon, provided that it is integrated with the government's general budget procedures and plans. Adding an independent participant to the commission overseeing the procurement process should also be done as quickly as possible.

We also agree that the HIV/AIDS epidemic is a critical issue requiring immediate intervention. The 1998 UNAIDS figures for Cameroon show the HIV rate at 7 percent among adults; once the rate surpasses 5 percent, it tends to soar rapidly. The HIV/AIDS epidemic is therefore no longer just a public health issue. It is a development issue. We welcome the government's ownership of this issue and urge timely implementation of its plans. We expect to see attention paid to this issue in the interim PRSP, and the full PRSP.

On the PRSP process, the government should be commended for its consultation efforts in March and April. Canadian field representatives report some 80 meetings were held with community groups representing larger stakeholders' groups throughout the country. Inter-ministerial teams were created to meet with these community groups in an effort to assess the extent of poverty in the country and to listen to their concerns and recommendations. This process is particularly commendable in a country which is highly centralized in its decision making, and in which there is no tradition of consultation, let alone participation. We look forward to the authorities building upon this good start by inter-ministerial teams or an equivalent, returning to meet with the stakeholders to discuss findings and recommendations stemming from these consultations; and, by broadening and institutionalizing the consultative process.

Finally, I would like to note that Canada has pledged to forgive all pre- and post-cutoff date debt following Cameroon's reaching the completion point.

Mr. Macia made the following statement:

Cameroon has been successful in implementing the first two annual arrangements of the PRGF-supported program. In the period 1998/99, real GDP slowed to 4 1/2 percent from a 5 1/4 percent program affected by adverse terms of trade on export commodities and oil prices. Inflation continued to be subdued in its downward trend, and the external current account deficit (including grants) widened to 4 1/2 percent of GDP. Gross domestic investment increased slightly, implementation of structural reforms continued, and privatization in the parastatal sector, including water and the liberalization of the energy and transport sector, have strengthened private sector participation and external competitiveness.

Consistent with program targets, quantitative and structural performance criteria were met for the first half of fiscal year 1999/2000. Though some benchmarks were missed for end-March 2000, for the second half, public finances were strengthened given higher oil prices, privatization proceeds, and the upsurge on non-oil revenues from a strong domestic tax revenue. The macroeconomic stance and structural reforms remained on track.

Holding on to an improved fiscal position is crucial for Cameroon given the objective to target increasing resources for human development, infrastructure, and poverty reduction. In this context, tax administration should be improved, the value-added tax strengthened, the tax base broadened, and the efficiency in domestic tax revenue and forestry tax collection institutionalized. We totally agree with the steps taken by the authorities to strengthen expenditure management as explained in paragraph 21 of the staff report. In the customs sector, efforts should be directed to revamp clearance and export procedures, implement the inspections system and increase internal audits, and firm up controls on exemptions. We commend the authorities for the latest controls to combat fraud and smuggling. These issues are consistent with the authorities' commitment to improve governance, combat corruption, enhance accountability, and change the country's negative perception among donors, whose participation in the HIPC endeavor is crucial.

The Bank-Fund team assessment under the FSAP pilot project identified the need to strengthen the regulatory and prudential frameworks in the banking system and bring them up to international standards. The modernization of the payments system is considered crucial to growth and expansion of the financial scheme. Legal and judiciary frameworks need to be improved, supervision and regulatory enforcement on the microfinance institutions must be strengthened to assure protection to depositors, the business climate must be enhanced, and the sector's development possibilities (Box 3) must be promoted further.

Reaching the decision point promptly for the enhanced HIPC Initiative is unique to Cameroon's options for debt relief and to reach out to the poor with targeted social programs. Our chair looks forward to receiving the I-PRSP for decision point in September promoted within an all-inclusive participatory process, clear sectoral strategies, and an improved target distribution and accountability in the use of public resources. In this regard, a reliable data base is crucial, and in addition to the technical assistance needs identified for the monetary and public sectors, social data collection and analysis of social and poverty indicators will be enhanced through Cameroon's participation in the GDDS and the ROSC pilot projects. We commend the authorities for the progress attained and concur with the staff's recommendations and the extension of the commitment period to December 20, 2000.

Mr. Wong made the following statement:

I would like to thank staff for a timely and excellent set of papers, and Mr. Barro Chambrier for his helpful and comprehensive preliminary statement. I think it is both appropriate and efficient for the Board to consider these documents in the same meeting. I welcome the opportunity. Since I broadly agree with the views of staff, let me offer a few comments here only for emphasis.

The authorities of Cameroon are to be commended for their satisfactory performance in the economic programs under the first two annual PRGF arrangements and the first half of the third arrangement, meeting all quantitative and structural performance criteria and benchmarks. They should also be commended for achieving admirable macroeconomic performance, with real GDP now projected at 4.2 percent for 1999/2000 and inflation contained below 2 percent. Recent monetary developments all seem to have become increasingly favorable.

Some quantitative benchmarks were missed for end-March 2000, but it seems to me that, generally speaking, corrective measures were introduced and problems have now been taken care of. However, I note that in the staff statement, the staff still expresses concerns, although it considers that targets can be met by end-June. For the oil revenue part, the shortfall appears to be caused by a technical problem, and the authorities and Mr. Barro Chambrier have reiterated that the target will be met by year-end. For the non-oil revenue part, I would like to ask whether staff concerns stem from the effectiveness of the tightened controls on customs administration in closing the gap. Their comments are appreciated.

I am impressed by the progress made in the tax and structural reforms, which should help bring the economy to a sustainable growth path. I agree with staff that it is time to consolidate these gains achieved and focus future

resources and efforts on improving the efficiency of government spending, broadening the tax base, fighting tax fraud, and enhancing transparency and accountability of fiscal operations. In this regard, I am sure that Cameroon will benefit tremendously from the ROSC Report, and trust that the authorities would make use of it and direct resources to areas where remedies and efforts are necessary. I hasten to add that I am very pleased to see the authorities already moving swiftly in this direction. And I very much appreciate staff's efforts in this connection. Suffice it to say, without their technical assistance, progress would have certainly been much slower than achieved.

Given the sound performance in the economic programs under the PRGF arrangements, Cameroon merits our support. Regarding the authorities' request for the extension of the commitment period of the program, I am on their side. On eligibility of the enhanced HIPC Initiative, the preliminary assessment from the DSA has already provided a clear answer to this question, and I of course will go along. I support debt relief under the Initiative during the interim period between the decision and completion points. As regards timing for the decision point, September is fine by me. For the set of data to be used, I have no problem in using the end-June 1999 data, unless staff are expecting a considerable difference in the outcomes if end-June 2000 data are used. Please say-so if this is the case. I suggest that if we are going to use 1999 data, it would be useful if staff could also provide the calculations based on data projected by them for 2000 for comparison purposes. But, in any case, let me emphasize that we should not be bogged down by the availability of 2000 data and delay the decision point at the expense of Cameroon.

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

The staff representative from the African Department, in response to Mr. Morais's question on the assessment of the participatory process for the preparation of the PRSP, indicated that the assessment involved the authorities, members of civil society, members of the international community, and, by extension, World Bank and Fund staff. There had been some apprehension before the process began, given the lack of local experience in that area, and given that Cameroon was a country of over 280 ethnic groups, with two official languages. It was encouraging that the participatory process had so far been conducted in a manner that was broadly perceived to be satisfactory.

On the question of the extent to which the staff had taken the country's capacity constraints into account, and whether a medium-term technical assistance program provided by the Fund, the Bank, and other institutions would be suitable, the staff representative pointed out that Cameroon had already benefited from technical assistance from the Fund. There were two resident experts in the country, one advising the government in the area of domestic taxation—in particular, the successful implementation of the value-added tax—and another in the area of expenditure management, where progress was encouraging. The Fiscal

Affairs Department was also providing expertise in the area of customs administration, and it was hoped that more direct and more durable assistance could be provided in the near future. This was reflected in the design of the PRGF-supported program. In addition, in the area of privatization, the World Bank was providing assistance in the elaboration of sectoral strategies for health and education, as well as for transport. Although the Fund-supported program was ambitious and there had been a few delays, the authorities had been able to implement the required policies in a fairly satisfactory manner, which indicated that they had sufficient capacity. In addition, the authorities had replaced what they considered to be insufficiently qualified individuals in various key positions, and that strategy appeared to be bearing fruit as well. A formal medium-term technical assistance program was nonetheless worth considering in collaboration with other colleagues.

With regard to Mr. Morais's question on the costs to the authorities of developing a poverty reduction strategy and monitoring its progress—and whether those costs had been incorporated into the fiscal scenario—the staff representative said that the costs for the current year were not significant. They amounted to about 250 million CFA francs, which was a small fraction of expenditure or reserves, for example. The authorities had approached the international community for assistance in that area, but had not yet received any positive reaction. The costs had therefore been absorbed by the budget, and there were several categories in the budget that enabled the authorities to finance that operation. If the costs were to become more significant in future years, they would need to be more explicitly budgeted. The staff would be following the issue closely.

On the issue of growth and employment prospects over the medium term, the staff representative indicated that medium-term annual growth in the non-oil economy was projected to reach 5.5 percent levels, rising gradually to 6 percent. The staff considered that to be a realistic target if the program were successfully implemented, and competitiveness were strengthened as a result of structural and sectoral reforms. Unfortunately, good data on employment and labor market conditions in the country were not available, and more work would need to be undertaken in that area. Data were available for employees of the Federation of Industrialists, but that was a small group employing only about 75,000 workers—a small fraction of the labor force. Nonetheless, there were strong indications that the informal economy was growing, and a study of national income accounts had tentatively concluded that inclusion of the informal economy would lead to an increase in GDP of 10 percent compared to official figures. Economic activity was therefore increasing, even though that could not yet be formally captured in the figures.

With regard to Mr. Morais's question on whether the high primary surplus target was not unduly restrictive, and his concern about the lower level of capital spending for 1999/2000, the staff representative indicated that the projection for capital spending had been lowered to be more realistic, in the light of performance so far and weaknesses in implementation capacity. While the original primary surplus target had been considerably lower, there had been a sizable increase in oil prices and—with it—in oil revenue. As a result, the primary surplus had been significantly increased. In view of the temporary nature of those windfall profits, the staff had consulted with the authorities on how best to use them. Given the remaining and considerable weaknesses in the expenditure management area, and

given that the original budget had been approved and that the authorities did not intend to request a supplementary budget from parliament, it had been agreed that the extra revenue should be used to clear domestic arrears that had been validated and to strengthen the external reserve position.

As Cameroon was a member of a regional central bank, its reserves position was to some extent hidden in the overall figures, the staff representative continued. However, until recently, that position was substantially negative and unsustainable. As a result of improvements, inter alia, in budgetary procedures and in the automaticity of the transfer of oil revenues to the budget, Cameroon currently recorded a positive position vis-à-vis the French Treasury, for the first time since 1988—a notable achievement. Over the medium term, the primary surplus would not need to remain at the same high levels, and with improvements in expenditure management and implementation capacity, the primary surplus would gradually diminish. The preliminary HIPC document showed that over the long run, the primary surplus would be reduced to levels that were comparable to those in neighboring countries.

On the question of the positive economic impact from reform in the areas of trade, taxation, access to credit, and regulations raised by Messrs. Pickford and Kelmanson, the staff representative remarked that—as had been highlighted in the selected issues paper for the 1999 Article IV consultation—the process was long, and barely a year had passed. In addition, the starting position of Cameroon was difficult. Perhaps developments in the informal sector could be considered as encouraging signs, but broadly speaking, in the formal economy the staff could not yet see significant changes.

With regard to the ending of the monopoly over the publication and distribution of schoolbooks, its significance in economic terms, and its importance relative to other structural criteria, the matter was among the foremost concerns of one of the federations of teachers that the staff had met, the staff representative said. The problem was not only one of distorting the market and passing higher prices onto consumers, but also of a lack of textbooks for much of the school year. There were also concerns related to governance and conflicts of interest, as the former Minister of Education was one of the major shareholders of the company supplying the textbooks. If children did not have textbooks, investment in human capital was bound to suffer, and the consequences would be felt over the long term. Thus, the Fund and Bank staffs and representatives of civil society considered that the authorities should be encouraged to suppress that monopoly as rapidly as possible. Also, in terms of credibility, it would have been difficult to say that the Fund-supported program was being implemented adequately and that progress was being made toward obtaining debt relief under the enhanced HIPC Initiative, while allowing to continue an obstacle that was counter to the spirit of the Initiative. The ending of the monopoly had therefore been considered highly important, and the measure had been taken satisfactorily in April 2000.

On the issue of the publication of information contained in the FSSA report and the ROSC, the staff representative said that the authorities intended to publish the ROSC modules and agreed to post them on the external website of the Fund. The fiscal transparency ROSC had already been posted, revisions and updates were being made to other modules,

and the financial sector module would also be added to the website. With regard to the possible tension with the implementation capacity of the country, and the question of whether those were the most important activities that Cameroon should undertake, the authorities had volunteered to participate in the pilot project on fiscal transparency and the FSAP pilot project, which did not require any resources on the part of the authorities, but mostly Fund and Bank staff. The staff considered that the resources allocated for those purposes were well spent, in the light of the importance of fiscal transparency and financial sector stability. The authorities were grateful for the work that had been done in those areas, and intended to implement the measures recommended by the staff. Technical assistance would be requested in that respect.

In response to Mr. Mirakhor's question on credit to small- and medium-sized enterprises, the staff representative observed that the financial sector had gone through several rounds of deep and severe crises, and that it would need to rebuild its confidence slowly and gradually.

The staff representative from the Monetary and Exchange Affairs Department confirmed that one should not expect a rapid development of bank lending to small- and medium-sized enterprises (SMEs), for two main reasons: first, the lack of accurate financial documents; second, the inefficiency of the judicial system for the realization of collateral. Consequently, in the short term, the financing of SMEs would have to rely primarily on microfinance institutions. In that regard, an appropriate framework needed to be developed for what was still a largely unregulated sector, and it was encouraging to note that the national and regional authorities were currently preparing new regulations with the help of the French Cooperation Ministry, which was providing technical assistance in that field.

The staff representative from the African Department, in response to concerns about the achievability of the decision point targets, acknowledged their ambitiousness, but considered that they were achievable and that work was underway in all the relevant areas. With regard to the HIV/AIDS initiative, World Bank assistance and UN aid were available, and the staff was cautiously confident that all measures could be met.

On the issue of military expenditures, the staff representative remarked that Cameroon had been involved in a military conflict in the border area with Nigeria that had not received much publicity, but where fighting had been ongoing for several years. The authorities had appealed to the International Court of Justice in the Hague, and the issue was still pending. In addition, the authorities were concerned that they needed to strengthen internal security, as small arms were in large supply throughout the subregion.

With regard to the current account deficit, the staff representative agreed that, without the increase in oil prices, it would have been 1.5 percentage points higher than programmed, owing to the fact that log exports had been 20 percent lower than expected, to lower aluminum exports, and to higher than originally projected imports, especially in the service account.

The contingency mechanism had served Cameroon reasonably well so far, the staff representative continued. With the exception of the end-March 2000 problem, oil revenue had been consistent with the program assumption. With regard to non-oil revenue, the preliminary numbers for April and May 2000 were encouraging.

The Deputy Director of the Policy Development and Review Department, on the issue of the nonconcessional loan for the Chad/Cameroon oil pipeline, said that, while the Bank had considered the option of providing financing on IDA terms for the project, there had been strong reservations among a number of IDA donors regarding the use of IDA funds for such a project. In the end, having considered all the options, it had been decided that the only feasible way to mobilize the necessary consensus and to go forward with the project would be to provide financing on IBRD terms, recognizing that this was a one-off exercise and that the project would generate significant amounts of foreign exchange.

Mr. Cippa' expressed his concern that this type of one-off operation could apply to any other country facing similar circumstances.

The staff representative from the World Bank indicated that the critical point to note was that no relief would be provided on the pipeline project, as disbursements would begin after July 1, 2000. That was well after the projected cutoff dates—whether June 1999 or June 2000.

Ms. Redifer asked whether Bank funding for the oil pipeline project could be reconciled with the Board's position that nonconcessional borrowing was inconsistent with the delivery of HIPC relief.

Mr. Cippa considered that the point that disbursements would come after cutoff dates was not satisfactory, and that the aim of debt relief was not to ensure that borrowing practices could continue unchanged.

The Acting Chairman remarked that the issue hinged on a technicality, and that the approval of the loan did not violate any rule. Given that disbursements were to occur later than the cutoff dates, the question then became whether the project should proceed, and whether the fact that IDA providers were not willing to finance it was a sufficient reason to block a project that would generate considerable foreign exchange. That would be tantamount to having an element in the HIPC design encouraging the discarding of important projects that made economic sense.

Mr. Kelmanson said that, while he agreed that there were not necessarily any technical breaches involved, he considered that Mr. Cippa and Ms. Redifer had a reasonable policy concern, and that similar cases in other countries were likely to arise. One example was the case of Guyana and GUYSUCO—the sugar company in that country—which was a key revenue earner for the economy. In that case, the Bank had rightly been taking a strong line, saying that no nonconcessional financing for the company could be envisaged. It was therefore necessary to find an appropriate way to balance difficult competing priorities.

The Deputy Director of the Policy Development and Review Department, on the issue of the best way to ensure that the future borrowing strategy of HIPC's would be consistent with their ability to repay, said that the staff's position so far had been to envisage that the aggregate terms on which those countries would borrow would include a grant element that would be consistent with the ability to repay, and to anticipate that, in the vast majority of cases, that would preclude any significant borrowing on nonconcessional terms. In the case under consideration, the aggregate terms were considered consistent with the authorities' ability to repay, not least because the ability to repay was significantly enhanced by the project. Given the financing options and the benefits of the project, it was deemed worthwhile to go forward with one significant nonconcessional loan within the aggregate ceiling.

Mr. Cippa' asked if the aggregate repayment capacity included HIPC debt relief, and wondered why it was necessary for the government to guarantee the project if it was considered viable.

The Deputy Director of the Policy Development and Review Department remarked that his understanding had been that while the project had been considered viable in financial terms, the private financiers associated with it had been unwilling to go forward without a government guarantee, in turn co-guaranteed with the World Bank. With regard to the question on the aggregate repayment capacity, the set of projections in all HIPC decision point documents had included an expectation of future borrowing and the terms associated with it following HIPC relief. In that sense, it was a post-HIPC analysis.

Ms. Redifer wished to know on what criteria it could be determined that another country would not qualify for a similar one-off measure.

The Deputy Director of the Policy Development and Review Department replied that the justification for going forward with the project under consideration was that, even if the loan associated with it were provided on nonconcessional terms, the combination of equity and nonconcessional borrowing would generate a revenue stream that would be sufficiently large to compensate for the costs involved, and that the impact on the projections of the country's borrowing and repayment capacity was such that the risk on the liability side was not deemed excessive.

The staff representative from the Word Bank remarked that the crucial point was that the pipeline project was a major poverty reduction project for Chad, although it was somewhat marginal for Cameroon. It was also worth bearing in mind that, in the case of both countries, the project was completely export-oriented. Therefore, it was unambiguously welfare-improving, and unambiguously improving the capacity to service debt.

The Acting Chairman, in response to Mr. Cippa's question on the need for a government guarantee, remarked that he had been told informally by the executive of one of the oil companies involved that they were not willing to invest in a difficult area of the world without some form of government guarantee. In addition, one of the three companies originally involved in the project had subsequently withdrawn, increasing the need for such a

guarantee. Considering that financing could not be provided on IDA terms, the only option left for the World Bank—which, in a manner of speaking, had become the lender of last resort for the project—had been to provide financing on nonconcessional terms. Given that the oil pipeline potentially represented a considerable source of foreign exchange, particularly for Chad—one of the poorest countries in the world—the decision had been taken to proceed with the loan, without violating any of the conditions of the PRGF or the enhanced HIPC Initiative. Although similar circumstances were highly unlikely to arise in another case, the staff could be asked to further examine the implications of that decision for other countries, and to consider whether it would be necessary to modify the basis on which no nonconcessional borrowing was to take place under the Initiative.

The staff representative from the African Department observed that, with regard to the safeguards on the use of revenue generated by the pipeline, the overall amount for Cameroon would not exceed 3 percent of total budgetary revenue. Therefore, unlike in the case of Chad, the amount was not highly significant. Nonetheless, the precautions and the measures undertaken in the broad area of expenditure management would also apply in that case. On the issue of governance, according to the information provided by the authorities and Mr. Barro Chambrier, all the necessary measures were being taken to meet the relevant benchmark by end-June 2000. Lastly, with regard to Messrs. Collins and Kelmanson's concern about the possible lack of consistency between the description of the uses of public expenditure in the staff's documents on Cameroon and the claim by other Fund missions that this should be left to the World Bank, the staff considered that there was no inconsistency, and that there was a clear division of labor between the Fund and the Bank. The focus of the Fund staff had been on technical assistance for aspects related to expenditure management, while Bank staff had been involved in assessing the composition of expenditure, and the specific programs and projects associated with it.

The staff representative from the World Bank indicated that the transit fees from the pipeline would flow directly to the treasury. Accounts would be audited, and those audits would be made available at least to the IDA. Therefore, a guarantee was in place for the transfer of those funds on the expenditure side, and the Bank was working with the Fund and the authorities to improve the overall quality of expenditure. On the issue of governance, the Bank was working closely with the authorities to establish a detailed action plan with respect to governance and anti-corruption, which would focus on the realization of the decision point and completion point triggers, as elaborated in Box 3 of the preliminary HIPC document.

Mr. Barro Chambrier thanked Directors for their support and the constructive remarks that would be conveyed to the authorities. He also thanked the staff for the concise answers provided to the questions raised.

The provision of financing for the pipeline project represented a positive development for both Cameroon and Chad, Mr. Barro Chambrier continued, especially in terms of the resources that would be generated. The project would create new employment, contribute to the fight against corruption and improve regional integration. However, there was no room for complacency, and the authorities in both countries were committed to make the best use of those resources.

Directors' concerns regarding the level of military expenditure, which had increased significantly during the previous year, for the reasons explained by the staff, would be conveyed to the authorities. It was important that those expenditures should be fully integrated in the budget, which was already the case, and that all the procedures to control those expenditures were in place.

On the issue of governance, Mr. Barro Chambrier took note of the Board's views, and considered that it was worth bearing in mind all the measures that had already been implemented by the authorities to improve governance—measures such as the dismissal of high-ranking officials, the mechanism to transfer oil receipts to the budget, the quarterly report on expenditures of key ministries, participation in the FSAP pilot project and the ROSC initiative, the audit of the government's procurement, and the preparation of a comprehensive strategy aimed at improving governance and reducing corruption that will be finalized before June 2000. The process was therefore in place, and the authorities needed to be encouraged.

The authorities were committed to implement forcefully the ambitious reform agenda described in their memorandum of understanding, and were determined to achieve successfully their economic and financial program under the PRGF, Mr. Barro Chambrier added. As had been indicated by some speakers, it would be necessary to strengthen administrative capacity in order to implement a highly ambitious program, and sequencing of reforms would be critical in that regard. Of particular importance, the authorities would focus during the last part of the third annual program on accelerating the pace of structural reforms in various areas, and pursue fiscal consolidation through the re-enforcement of nonoil revenue collection, transparency in the transfer of oil revenue to the budget, and better expenditure management. Measures implemented under the Fund-supported program had improved the economic welfare of the population, but still remained insufficient to reduce significantly poverty, and would need to be enhanced in that regard.

In that context, and based on the updated DSA, Mr. Barro Chambrier welcomed Cameroon's eligibility, probably around September 2000, for debt relief under the enhanced HIPC Initiative, as indicated in the preliminary HIPC document. To that effect, the authorities intended to speed up the process for the preparation of the interim PRSP for the decision point, and the process of consultation with civil society representatives and donors would gain momentum. The authorities would also be identifying targets for improvement in the areas of primary health, education, and access to safe water.

The authorities were committed to increase transparency in the privatization program, but also in the fiscal and financial areas, as demonstrated by their participation in the FSAP pilot project and the implementation of standards and codes on fiscal transparency, Mr. Barro Chambrier indicated. With regard to the recommendations of the FSSA report, the authorities' aim was to contribute to enhance the capacity of the COBAC, which was doing important work on supervision and the restructuring of the banking system.

Nevertheless, all those efforts would not be sufficient without continuous and adequate levels of external concessional financing, Mr. Barro Chambrier said. His authorities were committed—beyond the current PRGF that would end soon—to implementing all the measures that would ultimately lead to the completion point. This was a challenge for Cameroon, and Directors' support would reinforce the incentive for the authorities to persevere with program implementation and to increase their ownership of the program.

Mr. Barro Chambrier concluded by thanking Directors for their support of the authorities' request for the completion of the review and the extension of the commitment period, as well as management for their backing during the previous three years. He joined his authorities in expressing their appreciation for the good work done by the staff of the Fund and the Bank.

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

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Cameroon's satisfactory overall performance in 1999/2000 and noted that, despite difficult conditions in the non-oil export sector, economic growth has been sustained; inflation is in check; and the external current account deficit is expected to narrow, owing to favorable oil prices. Nevertheless, despite continuous improvement in economic conditions since 1997, the economy is still fragile and poverty remains widespread in Cameroon. Directors stressed that, in order to ensure lasting and high quality growth, the authorities will need to establish a solid foundation for the next phase of reforms. In particular, they emphasized the need to strengthen budgetary performance, to reinforce structural adjustment efforts and, most importantly, to enhance transparency and proceed vigorously to improve governance. Directors endorsed the broad-based consultations under way for the preparation of the Poverty Reduction Strategy Paper (PRSP), and looked forward to the completion of a well-defined strategy in the health and education sectors and for poverty alleviation.

On the fiscal front, Directors welcomed the satisfactory performance of domestic non-oil revenue, in particular the strengthening of the value-added tax (VAT) collection, and the improvement in the transfer of oil revenue to the budget. They noted the authorities' efforts to further consolidate the fiscal stance for 1999/2000, in a context of higher-than-programmed oil revenue and privatization proceeds. Directors stressed that measures to widen the tax base, increase efficiency at customs, and tighten control on exemptions were needed to further enhance the authorities' revenue mobilization efforts.

Directors expressed concern about the very low efficiency of public expenditure, and urged the authorities to implement diligently their action plan to improve budgetary allocation, strengthen expenditure management and control, and provide data on treasury balances in a timely manner. They noted

that the authorities' efforts to prepare detailed strategies for the social sectors should ensure better targeting of spending, stronger staffing, and improved service delivery.

Directors noted the authorities' efforts to clarify the domestic arrears situation. They regretted the delay in meeting the original target for the establishment of a comprehensive multiyear settlement plan, and urged the authorities to proceed swiftly in that area.

Directors noted the progress made in the implementation of structural reform, although at a slower pace than had been envisaged. They observed that the privatization of public utilities is gaining momentum and urged the authorities to expedite the privatization operations currently under way in the agro-industrial sector.

Directors noted the efforts by the government to improve transparency and fight corruption. They welcomed the measures being taken to strengthen governance, in particular in the area of public procurement and in the petroleum, public works, and forestry sectors. Directors emphasized the importance of a strong judiciary and regulatory framework in stimulating private investment.

Directors welcomed Cameroon's participation in the pilot Financial Sector Assessment Program (FSAP). They noted the encouraging conclusions of the Financial System Stability Assessment (FSSA) report, but stressed the need to monitor closely the few banks that remain vulnerable, and to streamline the nonbank financial sector. They urged the authorities to continue ongoing efforts to modernize the payments system.

Directors noted that the country's external debt burden remains heavy. They stressed that continued progress in implementing the authorities' medium-term program and completing the social sector strategy should help mobilize the needed international support, including under the enhanced HIPC Initiative, to alleviate Cameroon's heavy debt burden. Directors also encouraged the authorities to accelerate the reconciliation work on the commercial debt so as to begin negotiations with commercial creditors as soon as possible.

Directors urged the authorities to continue to improve the macroeconomic and social indicators database and to ensure timely dissemination of statistics. They welcomed Cameroon's participation in the pilot project on fiscal transparency, the GDDS, and the ROSCs on the monetary and financial sector and on data; they also welcomed the authorities' decision to make public the ROSC modules on the monetary and financial sector.

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

The Acting Chairman made the following summing up of points relating to the midterm review of the third annual arrangement under the Poverty Reduction and Growth Facility:

In considering the midterm review of the third annual arrangement under the PRGF, Executive Directors welcomed Cameroon's satisfactory performance during the first half of the program year. However, they regretted that, during the third quarter, the program's fiscal objectives could not be achieved and various structural reforms were delayed. Directors noted the corrective measures taken by the government to redress these problems, in particular the decision to commence negotiations with the successful bidder in the privatization of the water company (SNEC), and the adoption by the national oil company (SNH) of international accounting standards. They welcomed the close collaboration between the staffs of the Fund and the Bank in assisting the authorities in the formulation of their economic strategy.

Directors underscored several areas that are critical to ensuring the successful completion of the program. A key area is enhanced fiscal discipline. They urged the authorities to continue to monitor closely the execution of the budget and ensure that the fiscal targets of the second half of the year are met. To that effect, it is important that nonoil revenue collection be reinforced through measures to improve the customs and tax administration and combat fraud, and that the government's plan to strengthen expenditure management and control be implemented rigorously.

In other areas, Directors urged the authorities to adopt and swiftly move to implement a comprehensive governance strategy as a core component of the reform agenda. They underscored in particular the importance of reform of the procurement system and the managerial and operational audit of SNH—two critical measures under the third annual PRGF arrangement.

Finally, Directors stressed that the challenge facing Cameroon is to consolidate the gains made over the recent years and establish a solid foundation for the next phase of reforms. In this context, they noted that the strategies for the health and education sectors will form key elements in the government's fight against poverty, to which the authorities are committed.

The Acting Chairman made the following summing up of the discussion on the preliminary assessment of eligibility for the enhanced Initiative for Heavily Indebted Poor Countries:

Directors discussed the preliminary document for Cameroon under the HIPC Initiative, and agreed that Cameroon is eligible for assistance under the

enhanced HIPC Initiative, in view of its status as PRGF-eligible and IDA-only country and its unsustainable external debt burden, even after taking into account relief provided under traditional debt relief mechanisms.

Directors noted the continued improvement in economic conditions since the start of Cameroon's PRGF-supported adjustment program in mid-1997. Particularly important were sustained per capita GDP growth, the containment of inflation, marked progress toward fiscal sustainability, far-reaching structural reforms, and significant progress in the liberalization of the energy and transport sectors. Directors welcomed Cameroon's satisfactory performance during the first half of the third annual PRGF arrangement. They noted the corrective measures taken by the government to redress the fiscal and structural reform problems encountered during the third quarter.

With respect to the timing of the decision point, Directors agreed that Cameroon could reach a decision point around September 2000, conditional on continued good performance under the third annual PRGF arrangement as well as fulfillment of the conditions proposed by the staff, including the preparation of an interim Poverty Reduction Strategy Paper (PRSP). In that connection, Directors welcomed the broad-based consultation underway for the preparation of the PRSP, and made a number of suggestions that will be taken into account in preparing the decision point documents. Directors concurred with the staff that, if the decision point is reached around September 2000, the assessment of HIPC assistance could be based on end-June 1999 data.

Directors were in broad agreement with the proposals outlined in the preliminary document on the key structural reforms that should form the basis for reaching the completion point. They noted that they will consider those proposals, as well as the policy on which interim relief could be based, more fully at the time of the discussion of the decision point document. In that context, they considered that a credible framework for the PRSP will play a key role in ensuring that HIPC assistance is put to good use. They stressed that poverty reduction, improved governance, effective delivery of social services, and development of basic infrastructure constitute the appropriate enhanced agenda for the next generation of reforms. In particular, well-defined sector strategies and spending plans in the social sectors will have to be prepared, and better targeting and improved efficiency of delivery of the additional services will have to be demonstrated in the priority areas of health and education and poverty alleviation. Directors urged the authorities to develop a strategy to address the growing threat from HIV/AIDS. They also stressed the need to reverse the downward trend of social indicators and to combat corruption effectively.

Regarding the next step, Directors indicated that the authorities and the staff should proceed with consultations with Cameroon's other creditors and with the preparation of the decision point document.

The Executive Board took the following decision:

1. Cameroon has consulted with the Fund in accordance with paragraph 2.2(e) of the third annual arrangement under the Poverty Reduction and Growth Facility for Cameroon (EBS/99/153, Sup. 1, 9/9/99) and paragraph 5 of the letter dated August 9, 1999 from the Prime Minister of Cameroon. Cameroon has also requested that the commitment period of the three-year arrangement (EBS/97/138, Sup. 1, 8/22/97) under the Poverty Reduction and Growth Facility be extended to December 20, 2000.

2. The letter dated May 23, 2000 from the Prime Minister of Cameroon shall be attached to the third annual arrangement under the Poverty Reduction and Growth Facility, and the letter dated August 9, 1999, from the Prime Minister of Cameroon with its annexed memorandum, shall be read as supplemented and modified by the letter dated May 23, 2000.

3. Accordingly, the quantitative performance criteria referred to in paragraph 2.2(a) of the third annual arrangement under the Poverty Reduction and Growth Facility shall be as specified in Table 1 of the letter dated May 23, 2000 and the structural performance criteria (paragraph 2.2(b)) shall be as specified in Table 2 of the letter dated May 23, 2000.

4. The Fund decides that, before completion of the final review contemplated in paragraph 2.2(e) of the third annual arrangement, the Fund will appraise Cameroon's progress in implementing the policies and reaching the objectives of the program supported under the third annual arrangement, taking into account primarily the macroeconomic indicators and the structural benchmarks specified in Tables 1 and 2, respectively, of the letter dated May 23, 2000.

5. The Fund decides that the midterm review contemplated in paragraph 2.2(e) of the third annual arrangement under the Poverty Reduction and Growth Facility and paragraph 5 of the letter dated August 9, 1999 has been completed, and that Cameroon may request the disbursement of the second loan specified in paragraph 2.1(b) of the same arrangement.

6. The Fund approves the requested extension of the commitment period.

Decision No. 12209-(00/57), adopted
June 7, 2000

4. ROMANIA—STAND-BY ARRANGEMENT—REVIEW, EXTENSION, AUGMENTATION, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered a staff paper on the first review under the Stand-By Arrangement for Romania and its requests for extension, augmentation, and modification of the arrangement and for waiver of performance criteria (EBS/00/87, 5/17/00; and Sup. 1, 6/6/00; and EBS/00/94, 5/30/00).

Mr. Wijnholds submitted the following statement:

An Assessment of the 1999 Performance

Romania has been confronted with difficult challenges since embarking on the transition road to a market economy. To the initial stock of problems—a rigid economic structure, including the social dimension, and the low level of incomes—new ones have subsequently been added. Persistent political tensions have hampered the reform process, resulting in an increased cost of reform. Similarly, the recurrent failures to stabilize the economy until recently further eroded the political and public support for reform. Since 1999, however, economic policies in Romania have marked a clear turnaround in the right direction, including a significant overhaul of macroeconomic imbalances and substantial progress in structural reforms. The 2000 program—supported by a Stand-By Arrangement—is intended to build further on this progress and achieve a significant decline in inflation and the resumption of sustained growth. Against the background of the political pressures inherent in an election year, the authorities recognize that, for the program to be successful, any delay in policy implementation should be avoided.

The performance in 1999 can be summed up as follows. On the positive side, first and most important, the authorities avoided letting things get out of control, despite the prolonged economic decline (cumulative negative GDP growth of 15 percent since 1997), while also having to deal with severe weaknesses in the financial sector and a hump in the external debt service (\$3.4 billion, 48 percent higher than December 1998 gross reserves). Indeed, Romania avoided a default, despite the adverse starting conditions. In the same vein, fiscal and monetary policies proved to be strong contributors to the external adjustment and to limiting inflationary pressures. These policies, together with a substantial exchange rate depreciation, brought about a tremendous improvement in the operation of the foreign exchange market, and facilitated an orderly servicing of the external debt. Second, a massive adjustment of the external current account took place, of some 3.3 percentage points of GDP, associated with an important expenditure switch. Weak domestic demand and improved external competitiveness explain this outcome of the current account. Third, the Romanian authorities succeeded in

halting the hemorrhaging in the banking sector; two major state-owned ailing banks were decoupled from the system (one liquidated, and one now under restructuring and offered for sale).

On the other side of the coin three outstanding problems can be identified. First, in combating inflation, wage policy has persisted as the Achilles' heel over the years, including during 1999. The Romanian authorities recognize this weakness. Second, the implementation of structural reforms was uneven in 1999. As opposed to the restructuring of the banking system, the reform process at the enterprise level was less successful and large domestic payments arrears persisted (to the big utilities, and of those utilities to the budget), thus further generating inflationary pressures. Privatization, however, advanced at a satisfactory speed. Third, not only macroeconomic instability, but also the stabilization effort, if extended over a long period, could perversely affect enterprises. This is the result of the operation of imperfect markets and of uneven budgetary constraints among different groups of enterprises. In Romania, high real interest rates and credit shortages have hit the emerging private sector, mostly small- and medium-sized enterprises, relatively hard.

Recent Economic Developments

Recent economic and financial developments in Romania are encouraging. Output is reviving, reflecting both a prudent and coherent current policy mix, and the economy's own equilibrating mechanisms that operate after a prolonged decline. Preliminary data indicate an increase in GDP in the first quarter of 2000 over the corresponding period of 1999 of 1.5 percent. External sector developments are also positive: the current account deficit declined further over the first three months of the year to US \$38 million, representing only 13 percent of last year's outcome for the same period. A viable trade pattern seems to be emerging: both exports and imports are booming, suggesting that a recovery is indeed underway in economic activity. It is also expected that the real sector adjustment will result in foreign flows less sensitive to the business cycle. Mirroring these developments, the central bank has been a net purchaser of foreign exchange (of approximately US \$900 million as of May 26; last year the net purchases amounted to US\$700 million). The foreign exchange reserves of the central bank now amount to US \$1,700 million (US \$50 million higher than at end-December 1999), with the bulk of external debt payments for the year already having been made, and without official or private sector borrowing. Mixed news comes from the inflation front. Over four months prices went up by 13.7 percent, reflecting important relative price adjustments, including the impact of some fiscal measures. Indeed, with significant energy price adjustments to be announced in June, the annual target (27 percent) is likely to prove challenging. Preliminary data convey a better than programmed budget

performance in the first quarter. Finally, interest rates have declined recently, but are still positive in real terms.

The 2000 Program

Fiscal policy. Despite the protracted process of agreeing on fiscal policy, the final outcome can be viewed as a reasonable compromise. While having difficulties in agreeing on a consistent wage policy, the (new) government has succeeded in making serious inroads, mostly for the first time, in the realm of tax holidays, exceptions and reductions, and initiated other wide-ranging tax reforms. The deficit, at 3.5 percent of GDP, is consistent with the macroeconomic objectives. Apart from the comments presented in the staff report, broadly shared by the Romanian authorities, I would emphasize a few points. The budgetary wage problem should be seen more in terms of a general wage policy framework, rather than as a problem of the overall share of labor in GDP. The current approach to wage settlements (in the budgetary area) has suffered from a lack of consistency both from an intra-sectoral point of view, and in relation to other sectors' wages. Another point regards the decline in capital expenditure. The government is aware of this development and seeks to spend fully the budgeted allocations. Finally, the social sector problems have been better budgeted.

Incomes Policy. The government is aware of the key role incomes policy has to play with respect to inflationary developments and external competitiveness. The poor performance so far reflected mainly strong political pressures, but also insufficient policy resolve. The current program incorporates better-designed policies, and improved monitoring. Difficult measures have already been taken, such as those regarding the wages in the *regies autonomes*, national companies, and a number of large loss-making enterprises.

Monetary Policy. On monetary and exchange rate policies there is a full agreement between the authorities and the staff. The monetary program has struck a balanced approach, with a view to meeting the inflation objective, taking into consideration the external objective as well, while at the same time avoiding too tight a stance. The recent downward trend in interest rates has not been prompted by a relaxation of monetary policy, nor has it generated pressures on the exchange rate. This suggests that the tendency of interest rates to decline represents a validation by the market of the projected level of inflation, and a decline in the risk premium stemming from the improved performance of the government. The central bank is closely monitoring monetary developments to maintain a level of interest rates consistent with the macroeconomic objectives. As regards exchange rate policy, the central bank will continue to aim at conserving competitiveness by preventing an undue real appreciation of the leu.

Structural reforms. The problems in the banking system represented a major risk in 1999. For the current year the Fund program, in close cooperation with the World Bank, includes the privatization of one important bank, and a similar procedure for an unviable bank. For the latter bank, several investors have expressed their interest; if privatization does not materialize, the bank will be liquidated. The banking landscape in Romania is changing dramatically. Already at the end of 1999, majority foreign ownership increased to over 50 percent of the total number of banks. The performance of the Romanian banking system has gradually improved. In 1999 the solvency ratio rose from 10.3 percent to 17.5 percent.

Recent developments in the nonbank financial sector (the collapse of a mutual fund and cessation of payments by a credit cooperative) have added to the reform agenda new policy initiatives to urgently address the structural weaknesses of the financial sector in Romania. This action plan includes, among other measures, an overhaul of the regulatory and supervisory legal framework of the capital market, introduction of regulatory and supervisory legal procedures for credit cooperatives, and improvements in banking supervision in the area of banks' investment in nonbanking financial institutions.

As regards enterprise restructuring/ privatization the process has advanced significantly and the program is on track. This year marks a decisive stage in privatization. Most state-owned enterprises will be offered for sale, while the remaining loss-makers will be liquidated. Moreover, the restructuring process has also started for the large utilities. The gas company has been split into five new firms, three of which will be privatized. It is also the intention of the Romanian authorities to restructure the national energy company this year.

Since 1999 Romania has undertaken far-reaching steps toward eliminating major macroeconomic imbalances and implementing structural reforms. In particular, a massive external adjustment and an orderly service of external debt have been achieved. The difficult adjustment effort has been based entirely on market-based policies. The 2000 program is advancing credibly and in a consistent manner. Approval of Romania's renovated economic program by the Executive Board will provide a major encouragement to the authorities to continue the reform effort.

Finally, the Romanian authorities wish to convey to the staff and management their sincere appreciation for supporting country's efforts in developing its economic program.

Mr. Bernes made the following statement:

I would like to thank the staff for a well-written paper, and Mr. Wijnholds for a candid statement. It outlines the numerous challenges facing the authorities, describes an achievable set of objectives given the prevailing macroeconomic environment, and articulates a broadly reasonable set of policy measures to achieve these objectives. I am satisfied, in particular, with dropping the program's earlier requirement that the authorities tap international bond markets as part of our initial experimentation with private sector involvement. Judging by the out-turn on the external accounts, such a move would either have been superfluous, or it might have postponed (or even worsened) some of the necessary adjustment that eventually took place.

There are, however, significant risks involved with the proposed program. Recent developments have highlighted vulnerabilities in the bank and nonbank financial sectors. As well, given the policy slippages and delays that occurred in the second half of 1999, I am concerned about the authorities' capacity to implement some of the prescribed policies in light of the difference of views within the current governing coalition on budget priorities, and in the face of political pressures ahead of the upcoming elections.

Fortunately, implementation risk can be managed by the authorities. In this light, however, I think it would be useful to remind the authorities that the purpose of the Stand-By Arrangement is to assist in implementing adjustment policies with official financing. The recipient is expected to make the promised adjustments on schedule. The Romanian authorities must, therefore, ensure a timely implementation of the agreed policies if they hope to receive favorable reviews under the arrangement going forward. This applies, in particular, to the supplementary policy measures for strengthening the financial sector (a point to which I will return below).

One of the purposes of the program, as the staff points out, is to maintain the reform momentum through the elections later this year. Based on this, and based on progress made in a number of areas in 1999 that suggests a level of policy commitment deserving of Fund support, I am willing to approve the authorities' request for completion of the first review; to grant the requested waivers; and to extend the arrangement to end-February 2001.

Given the sizable external adjustment that has taken place, it seems reasonable to shift the program's focus slightly toward reducing inflation and implementing supply-side reforms to facilitate non-inflationary growth. Based on starting-point conditions and proposed policies, the current account deficit is likely to be financed by foreign direct investment over the course of the proposed Stand-By Arrangement, and as shown in Table 2 of the staff paper, Romania should run an overall balance of payments surplus in 2000, and be in a position to add significantly to international reserves.

This being said, Romania still has a way to go to adequately insulate itself from external vulnerabilities. Access to private capital markets is likely to remain difficult and costly, there are several significant amortizations of external government debt looming on the medium-term horizon, investors' confidence in the constancy of policy implementation needs to be strengthened, and the economy's export earnings potential needs to be further advanced and solidified.

Under these circumstances, the authorities cannot afford to ease policy efforts. With respect to fiscal policy, I agree with staff that an unchanged stance is appropriate to achieve the objectives set out for the coming year. To this end, the authorities will have to strongly resist political pressure for further increases in public sector wages. In theory, the authorities' suggestion that public sector employment could be further reduced to make room for higher average wages makes sense, since it moves in the direction of creating a lean, well-paid civil service. In practice, however, the required staffing reductions may be very difficult to implement in advance of the elections. Moreover, at the current conjuncture, further nominal wage growth in the public sector would have deleterious demonstration effects for the rest of the economy, making the program's inflation-reduction objectives more difficult to achieve. If the authorities insist on travelling this route, though, I would urge them at a minimum to implement employment reductions before granting additional wage increases.

The authorities will also have to strengthen efforts to reduce domestic arrears. The urgency of the problem is clearly indicated by the estimated level of total tax arrears to the consolidated budget (in excess of 10 percent of GDP), and the preliminary data indicating that enterprise arrears to the big utilities rose by about 10 percent in real terms in 2000Q1. The measures outlined to tackle the arrears problem constitute steps in the right direction, but this is clearly an area where more effort will be required. For example, based on the authorities' estimates, the proposed measures are expected to reduce arrears to the large utilities by around 15 percent in real terms over the course of 2000, only slightly more than offsetting the 10 percent rise registered in the first quarter.

Turning to monetary policy, while I concur with the broad objective of halving inflation in 2000, further work needs to be done to elaborate a sound framework for conducting monetary policy over the medium term. In the near term, it seems that the program overburdens monetary policy with too many targets. The third bullet of paragraph 23, for example, calls for the authorities to manage credit conditions to achieve a decline in inflation, while targeting the rate of crawl of the nominal exchange rate against major currencies, and targeting an increase in international reserves. Depending on the number of

instruments that the monetary authorities have at their disposal, it may be difficult (if not impossible) to achieve all of the targets simultaneously.

It is not clear from the staff report what is the instrument of monetary policy. Moreover, it is not clear what role the nominal exchange rate plays in the program's monetary-policy framework, and how the authorities would respond to unanticipated exchange-rate or inflation shocks. Is this a crawling nominal exchange rate peg (in which case an unanticipated positive inflation shock, for example, would be reflected in a higher-than-anticipated real exchange rate and possibly an overshooting of the target for the current account deficit), or is monetary policy targeting a path for the real exchange rate (in an attempt to safeguard last year's adjustment of the current account, but in which case there is no nominal anchor for the system). In either case, it is not clear that such an approach is sustainable over the medium term. Staff comments would be appreciated.

To my mind, since one of the authorities' key objectives over the course of the program is to reduce inflation, monetary policy should focus primarily on this objective, while allowing market participants to determine the appropriate value of foreign exchange. Clarifying the framework for conducting monetary policy, and simplifying the objectives of monetary policy, would reduce uncertainty over the implementation of monetary policy, thereby helping to stabilize expectations and reduce real interest rates.

Finally, the authorities made progress in 1999 in implementing banking sector reforms and in selling state-owned enterprises. Nevertheless, state ownership of enterprise remains high, and the financial sector remains fragile and a major source of vulnerability. The recent turbulence in the financial sector highlights the need for the authorities to move forcefully in improving supervision of both the bank and nonbank financial sectors, in order to come to terms with the existing state of affairs, and to identify and deal with potential difficulties. I urge the authorities to press ahead vigorously with their commitment to privatization in this important area, to strengthen supervision and the regulatory and supervisory legal framework, and to improve the operation of the Asset Recovery Agency.

Mr. Shojaeddini made the following statement:

As is clear from the lucid and balanced staff report, Romania made significant progress in 1999. Massive effort at fiscal and exchange rate adjustment resulted in strong external sector performance, cutting current account deficit to less than half of its 1998 level, substantial improvement in cost competitiveness, solid exports recovery, and a near doubling of official foreign reserves. Most importantly, against all odds, Romania managed to avoid a default and a banking crisis. Indeed, this progress was achieved at high domestic costs but, along with a marked advancement in the structural

reform agenda, it created the necessary conditions for output growth and lower inflation in the current year, while allowing some accommodation in support of economic recovery.

The pragmatic approach of the 2000 program deserves support as it strikes the right balance between maintaining the tight macroeconomic policy stance and further deepening and broadening the structural reform agenda, as elaborated in Mr. Wijnholds's helpful statement. The program is expected to help consolidate and safeguard the gains from the 1999 adjustments, as well as accelerate the pace of structural reforms and provide a direction for the future policy choices. While realistic, however, the program is appropriately ambitious, as is evident from the conditionality agenda in Appendix III of the staff report. To achieve maximum benefits from the program, far better policy coordination, stronger adherence to the program objectives, and closer, more effective dialogue with the Fund than in the past are required. The staff report is correct in underlining the fact that, given the circumstances of Romania and the degree of fragility of market confidence, there is little choice other than a diligent effort at full implementation of the program. A market perception of weakening resolve in this direction will erode further the confidence of participants. The stakes are indeed high and the risks to the program too realistic to underestimate the challenges facing the authorities.

On the macroeconomic side, meeting the fiscal target requires tough and resolute determination in view of revenue decreases resulting from the already implemented fiscal reform package, planned expenditure cuts, and the need to contain wage increases; all in a difficult political environment of an election year. Attaining the inflation target of halving the rate by end-2000 will pose a serious challenge in view of increases in utility prices and a 4.8 percent inflation rate in April. Failure to achieve the inflation target would complicate exchange rate policy as it would require a faster-than planned depreciation to maintain competitiveness and attain other external sector targets.

On the structural front, the authorities face a formidable challenge of meeting the conditionalities listed as structural benchmarks under the program with respect to financial sector reform and privatization and restructuring of enterprises. Here too, the staff report is correct in emphasizing that faithful adherence to implementation of these policies 'will critically influence the course of reform in Romania and investor perception.' In addition, the most recent developments in the nonbank financial sector indicate the urgency of addressing the structural weaknesses of the financial sector and the strengthening of regulatory environment and supervision. The overall important task for the authorities is to demonstrate a clear break with the past, when ambitious but poorly executed efforts at structural reforms were at the heart of stabilization failures.

Mr. Le Gal made the following statement:

I am glad that we are finally able to proceed to the first review of the Stand-By Arrangement with Romania. To say the least, this program has not been running smoothly and the outcome up to date is mixed. One of our main concerns when we approved the program was to support the implementation of reforms and indeed more was accomplished in the last year than during the eight prior ones. However, in considering the waivers requested today, one can see that the reform agenda has just begun and the Romanian authorities will have to be consistent and show a strong resolve to persevere and keep the program on track.

I concur with Staff and Mr. Wijnholds in saying that in 1999 Romania took a long step forward in terms of adjustment and reform. Mr. Wijnholds rightly says this is a turnaround. The tight fiscal policy actually contributed to the improvement of the external account, and in addition difficult and significant structural reforms, notably in the banking sector, have been made or are underway. These improvements must be acknowledged and the authorities commended for their implementation. However, one can only regret the slow pace of reform. The recent crisis of confidence illustrates that when we recommended moving rapidly with the reform it was not for the sake of speed, but because weaknesses in a banking system can burst into a confidence crisis very swiftly, whether or not fears are actually manipulated.

While we have to acknowledge the reforms which were implemented last year, the list of requested waivers illustrates how large the transition agenda still is. The disappointing performance on inflation also underlines that the stabilization is still fragile and that there are serious risks ahead.

In particular, the lack of financial discipline and the pervasiveness of soft budget constraint in various sectors of the economy point to an insufficiently advanced transition. The increases in domestic arrears (arrears to utilities which engender utility tax arrears as well as arrears from local authorities to the social funds) are all too characteristic of transition countries and call for immediate action. While the measures described in the MEP are a move in the right direction, the lasting solution lies in deep structural reform including corporate restructuring and privatization. What is the staff's view on the prospect of restructuring and privatization? What is the interest of foreign strategic investors? And, more generally, what are the prospects for an improvement of both public and private sector corporate governance?

Last year, at a time when the program assumed a small slowdown, inflation increased from 40.6 percent to 54.8 percent. In the meantime the exchange rate depreciated by more than 50 percent. Figure 5, page 28 'visually' understates the devaluation since it uses a log scale, but in fact the deterioration which occurred between November 1998 and April 1999 was

quite dramatic. Indeed, there was no peg to be broken, but this phenomenon could well be qualified as a currency crisis. In our view this devaluation of the exchange rate is the result of the bad external situation of Romania in 1998 and is the main trigger of the inflation surge in 1999. This underlines that a floating rate is not a panacea when macroeconomic policies are not in order. One can argue that the devaluation of a floating rate is less traumatizing than the breaking of a peg, but the recent rush on the BCR suggests that the difference is not so great. Furthermore, the external adjustment which has been made thanks to this large devaluation is likely to fuel a wage-inflation spiral. Indeed, the wage increases overshoot the target last year although one can wonder whether they were not only catching up for the inflation. Referring to page 30, wage increases apparently held 'in general' as envisaged under the program, except for the defense/security sectors, while the program ceilings were broken as a result of the upward revision of the basis. Looking forward and after the wage increase of late December and early January, how realistic is the government's target in terms of public sector wage bill after last year's real decline?

In the same vein, how realistic is a pension reduction in an electoral year? Moreover, could Staff elaborate on the social impact of the transfer from the pensions to the wages amounting to 0.4% of GDP as it appears in text table 2?

As a last point, I'd like to ask how well the Romanian authorities program fits in a larger strategy to join the EU ? Since the convergence process will require investments and reform how are these potential costs and benefits evaluated and prepared for in the budget?

With these remarks I support the proposed decision.

Mr. Jonas made the following statement:

Like Mr. Bernes, I thank the staff for their well-written and candid report. I am pleased that despite the difficult external and internal situation, the Romanian authorities were able to avert last year's threatened financial disaster. Indeed, given the difficult situation they faced, their progress with structural reforms and privatization has been remarkable. The staff concludes that the large corrections in the fiscal accounts and the exchange rate situation have created necessary conditions for output recovery. I would agree, but would add that the present conditions are not yet sufficient: output recovery will require much more to be done. Financial stability must be put on a sounder footing and structural reforms must be completed. The recent problems in the financial system have made this very clear.

First of all, I am concerned, primarily for reasons connected with fiscal policy, about the strength of the present financial stability. Last year's

adjustment of the primary budget balance, amounting to over 3 percent of GDP, is more impressive for its size than for its quality, for several reasons.

First, the costs of bank restructuring in 1999 were 1.3 percent of GDP less than projected.

Second, the fiscal adjustment strategy in 1999 was once more suboptimal. The suspension of costly tax incentives for investment and the elimination of tax exemptions were good moves, but some other features of the tax system are likely to have undesirable economic consequences. Particular examples are the very high level of social security taxes and the extension of coverage to workers with civil employment contracts.

Third, the problems of keeping budget spending under control persist. The pressure to cut taxes without first securing offsetting spending cuts is not reassuring. This is a risky approach. In addition, the large wage increase granted to certain groups of personnel was doubly unfortunate, not only for its direct effect on the budget, but also for its demonstration effects. Inadequate budget constraints in a major sector greatly increases the risk of wage contagion.

Fourth, the continued accumulation of arrears by local authorities and utilities is another threat to financial stability. The lax financial discipline of local governments is made more worrisome by the central government's shrinking share of the general government budget: that share is expected to fall rapidly. The erosion of central government revenues is accelerating, falling from 65 percent in 1998 to 47 percent in 2000. And given the increasing difficulty of controlling spending at the lower levels of government, this ongoing decentralization of revenues could make it more difficult to conduct fiscal policy.

I fear that the less than optimal quality of 1999's fiscal adjustment implies that it will be difficult to avoid changing the stance of fiscal policy this year. The approach of municipal and national elections do not make it any easier to preserve last year's fiscal adjustment, or meet the unbudgeted costs of bank restructuring.

Turning to the general strategy of the economic program for 2000, I agree with its focus on improving the inflation-output trade-off, an area where there is much room for improvement. I agree that there is no urgent need to further reduce domestic demand or weaken the currency: for the time being, competitiveness does not seem to be a problem. But Romania's external position remains quite fragile. Even though I disagree with the alarmist views of some rating agencies about Romania's ability to service its external debt, the medium-term sustainability of its external position is far certain. It will require further progress with financial stabilization and structural reforms to

help preserve Romania's recent competitiveness gains and increase its access to private external financing. The medium-term balance of payments projection in the staff report contains only net figures. Could the staff tell us more about amortization payments in the medium term?

It has been many times repeated in this Board that the main reason for Romania's unsatisfactory macroeconomic performance is its slow progress with structural reforms and privatization. In 1999 there was a notable and welcome improvement in this area. Apparently the threat of crisis frightened the authorities into moving faster on structural reforms. I hope that they will be able to maintain the new reform pace without the spur of a looming crisis. Most of the largest enterprises are still under state control, and their privatization, restructuring, or liquidation will be much more difficult than that of smaller enterprises. Their continued accumulation of payment arrears suggests that, unrestructured, these enterprises are a continuing threat to financial stability and an obstacle to the effectiveness of monetary policy. The authorities' privatization plans for 2000 are certainly ambitious. Implementing them as intended would be a major achievement.

Like Mr. Bernes, I believe it is urgent to reduce domestic arrears. However, I find the target of reducing arrears by 15 percent in real terms in 2000 to be quite ambitious. First, the arrears have increased by some 10 percent during the first quarter of the year, so that reducing them by 15 percent for the year as a whole means reducing them by some 25 percent in the six and a half months that remain. Second, if we look at the targeted arrears reduction from the standpoint of flows rather than stocks, this will require a it implies a substantial tightening of budget constraints on the enterprises that have been responsible for accumulating these arrears in the past.

We must be realistic and avoid counting on further substantial progress with fiscal and structural reforms during the period preceding the municipal and national elections. The staff points out that the main purpose for the Fund to stay involved in Romania is to preserve some of the reform momentum and prepare a better platform for the policies of the next government. The new government's chances of completing the demanding agenda of economic reforms will certainly be better if the past year's achievements can be preserved, if pre-election spending pressures can be kept in check, and if backsliding in the structural area can be avoided. I hope that today's completion of the review can assist the achievement of this objective.

I support the completion of the review.

Mr. Yanase made the following statement:

As clearly explained in the staff report and Mr. Wijnholds's statement, the progress made since the last Board meeting has been mixed. The good news is that external adjustments have been made more drastically than expected under the program. The bad news is that other policy implementations, notably on the fiscal front and in income policy, are delayed and unsatisfactorily implemented. As a result, most of the end-December criteria under the Stand-By Arrangement were not observed. In addition, as Mr. Bernes noted, risks in the financial system and the need to address this problem become clear. While this chair strongly welcomes the achievements made so far and agrees with the staff that the program is appropriate, our major concern that Romania's poor track record on the Stand-By Arrangement programs may possibly be repeated has not been dispelled.

This chair emphasized at the Board discussion last August that the authorities' strong and sustained willingness to implement necessary reforms is an essential ingredient in restoring confidence and in achieving sustained economic recovery. Its importance has not been decreased, and I urge the authorities to show this willingness by undertaking policy measures outlined in the program. Particularly, the commitment to income policy measures must be made seriously, as they substantially affect inflation and fiscal situations.

On the program, the staff paper explains that there was agreement between the authorities and the staff to shift the focus of policies toward reducing inflation and supporting an export-led recovery, as well as promoting investments in output growth. I share this view, given the degree of external adjustment made so far, and the challenge now is how to make recovery firm and sustained.

This challenge is further complicated by the fact that the current account deficit is projected to enlarge in 2000, mainly due to an expansion of imports. Striking a delicate balance between the two goals, namely, firm recovery of the economy on one hand and improvement of the external position on the other, will be a difficult task. The program expects tight fiscal and monetary policy stances broadly to remain unchanged. While I agree with these policy stances, I would like to emphasize the need to conduct policies, in particular fiscal policy, carefully and skillfully to achieve these two goals.

On the fiscal front, the authorities hope to achieve the fiscal deficit target for 2000 partly through expenditure restraint. However, there is the risk that political pressure during an election year may lead to expenditure overrun. In addition, there will likely be a shortfall of revenue if economic recovery is less than envisaged. In my view, it is necessary for the authorities to prepare alternative measures in order to avoid missing the fiscal target.

Before concluding, I would like to touch on the issue of private sector involvement (PSI) briefly. This chair agreed to drop the PSI requirement given the improvement in Romania's external position. But, we still support the approach whereby a debtor country's request to relax the borrowing requirement is acceptable if it agrees to a reduction of official assistance to ensure fair burden sharing between the private sector and the official community. I understand the Romanian case can be treated as an exceptional one since it precedes establishment of our general approach to PSI. In future cases, the principle of relaxing the PSI requirement, which I mentioned, should be strictly observed.

With these remarks, I support the proposed decision and wish the authorities success in implementing the program's measures in a decisive manner.

Ms. Lissakers made the following statement:

Mr. Wijnholds in his statement has outlined both the government's accomplishments last year and Romania's shortcomings in terms of policy and performance, and I will not repeat the list, with which I agree on both sides of the balance sheet. And there are, indeed, significant accomplishments to point to last year. Nevertheless, and leaving aside the waivers that are being requested as part of this review, it is obvious, as others have pointed out, there are concerns about the viability of the program going forward.

First of all, as Mr. Jonas, among others mentioned, the program does not call for further consolidation of the fiscal deficit, which is substantial, even if improved. Given the lag in structural reforms, it would seem that a more aggressive fiscal policy would appear warranted. Even maintaining the level of fiscal performance called for in 2000 is based on certain optimistic assumptions, and recent developments point rather to weakening on the fiscal front.

Development of strict wage discipline has been absent in Romania heretofore, and wage growth accelerated in April. Even with large assumed cuts in public sector employment, the wage bill for the state budget is slated to rise by 56 percent in nominal terms, which raises concerns on the fiscal outcome and the inflation front. The program calls for reduction in persistent domestic arrears, but again, the situation appears to have worsened considerably in the first quarter of 2000. I note also that the program appears simply to discount the cost of restructuring Banca Agricola, which is likely to amount to at least 0.5 percent of GDP in 2000. Moreover, the program calls for very politically difficult expenditure cuts in an election year, including large reductions in both civil service and defense and security personnel.

The staff paper notes that there is limited room for non-inflationary domestic financing of the deficit, while external financing sources are clearly also limited, notwithstanding the improved foreign exchange reserve position; continued fiscal weaknesses or any worsening of fiscal performance would thus be very problematic on a number of accounts, including inflation.

Notwithstanding the newly developed measures in the supplemental Letter of Intent, the recent developments in the financial sector raise serious questions regarding the health of that sector, and the adequacy of corporate governance, prudential, and supervisory measures. The recent failure of the investment entity may not be large in terms of the total amount of money involved or fiscal impact, but it will have significant confidence effects, one would guess, given the backdrop of financial failures and loss of savings in Romania over recent years. That cost can be as great as any direct impact on the fiscal picture per se. Aggressive implementation of the supervisory and prudential elements in the sector obviously is critical both for viability of the financial institutions and the budget and for the rebuilding of public confidence in the country's currency and financial institutions.

Lastly, Mr. Bernes makes a very important point about monetary policy. It may have been possible last year to simultaneously manage or work toward all of these targets, but going forward, it seems to us not sensible to try to guide monetary policy on the basis of all of these objectives. We know from experience it does not work over any extended period of time. You need to pick one principal guide for monetary policy. You cannot have too many goals.

Mr. Merz made the following statement:

Let me first thank staff for their hard work over the past months in particular last week, in order to help stabilize the economic situation in Romania under quite difficult circumstances. I also want to thank Mr. Wijnholds for his informative and candid statement. I can be brief since our thinking is more or less along the lines of Mr. Bernes's and previous speakers.

The Romanian authorities should be commended for their commitment and for their continuous efforts to stabilize the macroeconomic situation of the country, especially the external situation, by pursuing a comprehensive reform agenda. This has led to progress on the structural front and a remarkable turnaround in the external position, also generated by large corrections in the fiscal accounts and the exchange rate—although at the cost of a further decline in output and higher inflation. It is also encouraging to hear that all prior actions have now been implemented.

Against this background, we can support the proposed decisions. This support should, however, not distract from the fact that the program faces many implementation risks, in particular in connection with the runup period and the outcome of the general elections scheduled to be held by November 2000. Let me briefly touch upon three specific areas of vulnerability:

First, on the budgetary front the achievement of the fiscal target for 2000 is at risk for several reasons. The implemented tax reform measures will involve significant revenue losses, despite abolition of various exemptions. On the expenditure side, wage spending is on the rise and confirmed by most recent data, despite the intended civil service staff cuts, triggered by high wage increases in the budgetary sector. This, in addition, will very likely have damaging demonstration effects for the outcome of the negotiation process for private sector wages. We share staff's and previous speakers' concern that the intended compensation measures, especially those related to social expenditures to offset revenue losses and public sector wage increases, will hardly be satisfactorily achieved in an election year.

Secondly, the problem of domestic arrears is still looming and has even deteriorated as evidenced by the considerable amassing of new arrears at the level of local authorities, utilities and enterprises. It is alarming that efforts to reduce domestic arrears through improved financial discipline have apparently not been successful. The authorities' response so far, as described in par. 31 of the staff report, is not totally convincing. More needs to be done in the context of a comprehensive approach to tackle this arrears problem.

Thirdly, the mutual fund episode of last week has demonstrated that the financial sector remains highly vulnerable. We commend the authorities for their quick and decisive response, but we also strongly endorse staff's and Ms. Lissakers's call for further urgent action to address serious weaknesses in financial supervision and governance.

Let me conclude with one remark on monetary policy. I fully share the respective remarks expressed by Mr. Bernes and Ms. Lissakers, in particular with regard to the fact that the monetary authorities are overburdened with too many targets.

With these remarks we wish the Romanian authorities much success in their future adjustment efforts.

Mr. Szczuka made the following statement:

I welcome the progress made by Romania under the current Stand-By Arrangement. At the same time, however, I am quite disappointed that due to the uneven implementation of the agreed program we have been confronted

today with the request to waive six of the ten quantitative performance criteria. While granting waivers is not something unusual in this Board's practice, our Chair attaches particular importance to the rigorous implementation of the agreed policy measures by the Romanian authorities, because in our view, as indicated already last August, both Romania and the Fund could hardly afford yet another failure of a Fund-supported program. However, taking into account the undeniable achievements in some important areas, and in particular the striking improvement of the external position and the visible progress in structural reforms, we are prepared to support the proposed decisions and accept the requests for waivers, completion of the first review and extension of the arrangement to end-February 2001. The very fact that Romania managed to stave off the danger of default and currency crisis can be seen as proof that, after all, this Board took the right decision when offering Romania, despite many doubts, also on the part of this Chair, the Fund's helping hand.

Substantial progress notwithstanding, our Chair, and in particular its main stakeholder, continues to see serious risks for the Romanian program. The key challenge for the authorities will be to consolidate the gains in reducing the external and fiscal imbalances, to achieve the ambitious disinflation target, and to put the economy on a sustainable growth path. Last year's decisive adjustment was in part forced upon the authorities by the threat of a default and by lack of external financing. As stated by Mr. Deppler last August, the authorities had to act because they had 'their back against the wall'. Using the same metaphor, we see a real threat that in an election year, and with the lessening of the external constraint, the wall of creditors that stood behind Romania last year, will be replaced with a wall of voters, who will push the government in a distinctly different direction.

We agree with the staff that there are considerable risks to the current budget. While last year's improvement stemmed mainly from major tax increases, additionally boosted by higher than projected inflation, the current fiscal program envisages quite significant revenue losses resulting from the wide-ranging tax reform. While the timing of this reform may be questionable its overall objective of creating a sounder and more transparent fiscal environment by simplifying legislation and lowering tax rates while broadening the tax base should be welcomed and supported. More problematic seems to be the assumption that it will be possible to compensate for the substantial tax cuts by reducing spending on subsidies, pensions and other transfers and by stricter wage discipline in the rest of the public sector outside of the budgetary sector. Also, it has been assumed that the large increase in the central government's budget from 2.6 percent of GDP in 1999 to 4.4 percent of GDP this year, will be compensated by turning last year's deficit in the rest of the general government into a sizable surplus. I would welcome staff's comments on the feasibility of the latter assumption given the indication of the increasing arrears of the local governments, problems with

the revenue sharing system between central and local budgets, and the still increasing losses of the state-owned enterprises. The prospects for introducing the envisaged spending cuts during an election campaign seem also to be quite uncertain. However, the biggest threat, not only to Romania's fiscal position, but also to achieving its ambitious inflation target and maintaining external competitiveness, stems probably from the government's poor track record in the area of incomes policy. This has been reflected in last year's big pay raises in the defense and security sectors, as well as in the more recent swift accommodation of wage demands in the education and mining sectors. In light of this track record, the government's expectation that the large real wage increases planned for the budgetary sector will not have a strong demonstration effect for the rest of the public sector and for the economy as a whole seems to be unduly optimistic. The apparent acceleration of wage growth in April reinforces our concerns relating to the incomes policy.

Adhering to the fiscal deficit target will be necessary to keep inflation under control. However, the announced inflation target—as indirectly admitted in Mr. Wijnhold's statement—may be overly ambitious and very difficult to reach. First, since there are neither any major institutional nor operational changes in the conduct of monetary policy, it is not clear why the authorities' inflation target, that has been missed every single year since 1989 should be more credible this time. I fully associate myself with Mr. Bernes' comments on the confusing multiplicity of targets of the monetary policy and the need to elaborate a sounder medium-term framework. Second, as already indicated earlier, given the nature of signals coming from the government's wage policy, it is rather hard to expect that there will be a moderation of wage pressures in the rest of the economy. Finally, the unification of VAT rates implies an increase from 11 percent to 19 percent of the rate for some essential items like basic food products, medical and pharmaceutical products, and urban transportation. Moreover, VAT for energy was increased from zero to 19 percent at the beginning of the second quarter of 2000. The staff report does not say anything about the likely impact of these rate increases on prices. Given this impact and the fact that inflation in the first quarter of 2000 was still running at a relatively high level, I would welcome staff's comments on the feasibility of the 27 percent inflation rate targeted for this year.

The recent developments that led to the closures of the largest mutual fund and the largest credit cooperative, and exerted strong pressures on the largest commercial bank, have revealed that despite important progress in banking sector reform and privatization, the Romanian financial system remains very vulnerable. The authorities' swift reaction helped contain the scale of the recent problems, but it needs to be followed by a strong effort to improve the institutional and regulatory framework that is indispensable to assure an effective supervision of the whole financial sector. It is quite unfortunate that the plan to extend the supervision to the credit cooperatives sector, envisaged under the current program, will only be implemented after

the occurrence of serious problems instead of serving as a tool to prevent them. The significant involvement with the failed mutual fund of the two large state-owned banks raises some important questions about the governance and regulatory oversight of these institutions' activities. Given the importance of the still unfinished reform of the banking sector, I would appreciate it if the staff could provide some data on the recent progress in reducing the share of bad loans and in strengthening the capital base of the Romanian banks.

Acceleration of structural reforms holds the key to assuring the sustainability of the emerging output recovery. Restructuring and privatization of the still very numerous state-owned enterprises should contribute not only to increasing efficiency, but also to resolving the long-standing problem of tax and payment arrears. Welcoming the recent acceleration in reducing the SOF assets I would, however, caution against putting too much stress on purely numerical targets. The quality aspect should not be neglected and the authorities should be able to respond to the critical comments suggesting that their privatization process, in particular in the banking sector, lacks a strategic vision. I believe that I understand the broad rationale for introducing the performance criterion that prohibits any further budgetary assistance to public enterprises. I wonder, however, whether this program condition may not be too rigid and whether there are really no cases where a limited financial support would result in either increasing the value of the enterprises being prepared for privatization, or reducing the losses that ultimately have to be covered by the budget.

To conclude, I would like to stress that thanks to the authorities' strong effort to reduce the external and internal imbalances the Romanian economy has, for the first time in many years, a real chance to fully exploit its growth potential. This opportunity can only be gained if the authorities prove their ability to reduce public expenditures, continue prudent monetary and exchange rate policies, move decisively on the structural reform front, and, last but not least, strengthen their resilience to wage demands, independent of the political cycle.

Mr. Lushin made the following statement:

The Romanian authorities can be commended for their efforts to keep the situation under control during the difficult circumstances of 1999. They undertook a large fiscal correction, which, together with the depreciation of the leu, helped generate a large external adjustment and thus allowed avoiding a financial crisis. However, despite visible improvements achieved so far, the economic situation remains fragile and the authorities need to double their efforts in order to ensure macroeconomic stability and create a foundation for healthy, non-inflationary growth. The 2000 program, if properly implemented, would allow moving significantly forward in this direction. Therefore, I can support the completion of the first review under the Stand-By Arrangement,

the extension of the Arrangement and waivers for nonobservance of performance criteria. This said, I urge the authorities to ensure a timely implementation of the agreed policies so that the program can be successfully implemented. The pattern of previous Fund-supported programs with Romania, which all went off track, should definitely be avoided this time.

I agree with the general thrust of the program, namely, that with sizable external adjustment already in place, there is no need to maintain the corrective macroeconomic policy stance envisaged by the initial Stand-By Arrangement for 2000. Therefore, the current program rightly concentrates on securing decline in inflation and supporting growth. The revised framework also allows keeping the stance of macroeconomic policies broadly unchanged while concentrating on pressing structural problems.

The fiscal part of the program is perhaps the most ambitious one, and it also involves the highest risks. I agree with the staff and previous speakers that expenditure cuts will be difficult to enforce in the election year, as well as to implement cuts in the public sector employment stipulated by the program. The income policy of the authorities aimed at deceleration of nominal wage growth will also be severely tested in the run-up to elections.

The above-mentioned tensions in the 2000 budget are, to a large extent, related to the tax reduction measures envisaged by the authorities. While I support these measures as a matter of principle, I wonder if the time of their introduction is quite appropriate. Turning to specific tax reforms, I share the staff's concern, which was also echoed by Mr. Jonas, about the extremely high level of social security taxes, accounting for 63 percent of gross wages. The already accumulated experience suggests that such a high level of wage-related taxation is a source of vast tax evasion and different fraudulent schemes. Therefore, lowering the burden of social security taxation should be high on the tax reform agenda of the authorities.

On monetary policy, I would like to associate myself with the remarks made by Mr. Bernes. Specifically, the role of the exchange rate policy is also not quite clear. It looks as though the authorities are not going to use the exchange rate as a nominal anchor, but they rather suppose to keep the real exchange rate relatively constant in order to preserve competitiveness. I wonder if they consider any scope for the real appreciation of the leu in the event of unexpected upward pressures on reserves. The main instrument of monetary policy will be targeting the net domestic assets of the central bank with heavy reliance on deposit-taking operations. For example, between March and June 2000 the monetary program envisages deposit taking by the central bank in the amount of almost 9 trillion lei, or around 22 percent of reserve money. I would like the staff to provide some more detail on the nature of these deposit-taking operations, including their potential impact on the interest rates. Owing to a strong external position there will be large hard

currency inflows, and, as the staff indicates, sterilization needs are likely to remain large in 2000. As authorities have committed to refrain from further increases in the reserve requirements, I wonder what sterilization instruments will be used this year. Specifically, is there any scope for open-market operations with T-bills, or will deposit taking be the main tool in this area?

I welcome progress achieved in bank restructuring and further steps envisaged in this area. However, the recent events on the financial market clearly show that the situation in the financial sector, in general, and in the area of banking supervision in particular, remains fragile. The authorities need to radically improve supervision of both bank and nonbank financial sectors.

The Romanian economy is heavily burdened with loss-making state-owned enterprises. Weak corporate governance and the lack of financial discipline in this sector resulted in productivity losses and accumulation of arrears. Although there was a visible acceleration of enterprise restructuring in 1999, the agenda in this area is still largely unfinished. Therefore, I welcome the authorities' plans in privatization and restructuring, including those under the auspices of the World Bank program.

With these remarks I reiterate my support for the proposed decision and wish the authorities every success in their reform efforts.

Mr. Xu made the following statement:

I welcome this opportunity to consider the First Review under the Stand-By Arrangement and the request for waivers of the performance criteria. I am grateful to the staff for the comprehensive report and to Mr. Wijnholds for his comprehensive statement. As the staff report indicates, the economy is broadly in line with the proposed financial program. All prior actions are now being implemented and, as Mr. Wijnholds has stated, recovery is, indeed, under way in economic activity. I would like to express my support for the proposed decision.

Since I am in broad agreement with the staff appraisal, I would like to focus my remarks on a few aspects.

First, I would like to express my appreciation of the flexibility demonstrated by the staff regarding the conditionality on private sector involvement initiative linked to the Stand-By Arrangement. As this chair argued during the August 5th, 1999 Board meeting, private sector involvement should not be made a condition of the Stand-By Arrangement. I welcome the decision to drop that program requirement. I fully agree with Mr. Bernes that, I quote, 'Judging by the out-turn on the external accounts, such a move would either have been superfluous, or it might have postponed (or even worsened) some of the necessary adjustment that eventually took

place.' In this regard, I would like to underscore that conditionality has to be realistic, otherwise, it can be counterproductive.

Second, I am reassured by the authorities' rapid response to the financial turbulence last week. In particular, I welcome the three-pronged approach and hope that the authorities will carry it out as planned. The episode underscored the need to strengthen supervision of both bank and nonbank financial institutions, as well as to build up the regulatory and supervisory capacity in the sector.

Third, I wish to associate myself with the remarks made by Mr. Bernes and previous speakers on the program's overburdening monetary policy with too many targets. I believe that monetary policy should primarily target low inflation.

Finally, despite the risks, I agree that by completing the First Review under the Stand-By Arrangement, we lend the authorities a helping hand in safeguarding the 1999 dollar adjustment and maintaining the reform momentum, thus providing the future government with a better platform for policy implementation.

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

Mr. Collins made the following statement:

At this late hour I will try to be reasonably brief. Romania has clearly made progress in adjustment during 1999. The large external adjustment is the most notable achievement in the economy, and, in many ways, the external account looks healthier than many of us could have predicted at the beginning of the year. This is a helpful step in the right direction, but we have seen a good many false starts before in this economy, where transition process has been prolonged and painful, and is far from complete.

Mr. Wijnholds gives us a useful update on recent developments, which notwithstanding events in the financial sector give some grounds for optimism. Unfortunately, over the last year there are clearly examples in some areas of policymaking where policy momentum may not be sustainable. The political environment, particularly the forthcoming election, is unlikely to make the job any easier, while a piecemeal package is unlikely to bring the results that Romania needs. I can support the completion of the review, as I believe that the Romanian authorities should be given appropriate encouragement to do all they can to maintain the momentum gained and to create the conditions conducive to higher growth and lower inflation. This will require strict adherence to the program, which, we should acknowledge up

front, is challenging both in the macro-policy and in the structural-reform agenda.

Both staff and Mr. Wijnholds have made clear the difficulties in the area of fiscal policy. If we look at the process in a positive light, we should have some confidence that at least there is government commitment to the approved budget, given the difficulty in reaching agreement. However, substantial downside risks associated with implementation of the budget remain. It is clearly a situation that we have to keep under close review as the various changes on the revenue side work their way through the system, and the pressures on expenditure grow.

On monetary policy, I share the views of those Directors who expressed concern that it might be overspecified.

The performance on incomes policies has been disappointing to date, although this is easier to say from this safe distance than within the country, I imagine. It is unlikely that public pressure on the authorities in this area will diminish, and it will be difficult to administer the policy for any length of time.

The buildup of arrears by local government and the state-owned enterprise sector is worrying. The message on hard-budget constraints is simple enough. The enhanced export opportunities are allowing some enterprises to improve their position. The government should ensure an environment where productivity and efficiency can be rewarded, but where persistent loss-making is ultimately seen as expensive.

Structural reform is at the core of the Stand-By Arrangement. I note progress under World Bank-sponsored adjustment lending has generally been good and hope that this will continue. Romania still lags very far behind its regional neighbors. Its future as a market-based economy fully integrated into European structures, ultimately means a serious and prolonged structural reform effort. Sustaining the effort over the period of this Stand-By Arrangement is only a start. Again, given the history, particular attention will be paid to the structural reform area in considering future reviews under the program.

Finally, the recent developments reveal just how fragile the financial system is. It is essential for Romania to take difficult decisions on banking reform and to keep on track in achieving specified targets. The steps agreed over the last week to strengthen supervision are important, although I do wonder if there is sufficient capacity in Romania to implement all the measures successfully. A view from the staff on that point would be appreciated.

The staff representative from the European II Department commented that the monetary and exchange rate policies foreseen in the program were appropriate under the current circumstances in Romania. The program envisaged an 'unannounced' crawling peg exchange-rate regime. The monetary authorities would not announce, or commit themselves to, a specific nominal exchange-rate path, because of the uncertainties surrounding the economic outlook and the equilibrium exchange rate. While the lack of preannouncement would weaken the role of the exchange rate as a nominal anchor, it was also true that the markets were more watchful of exchange-rate performance than of the central bank's announcements. Indeed, there was evidence that the recent exchange-rate developments had strengthened confidence and enabled a decrease in interest rates.

As regards the policy objectives including the choice of the exchange rate regime, the monetary authorities had to strike a delicate balance between supporting the external objectives and achieving inflation control, the staff representative continued. An inflation-targeting framework, by focusing on inflation at the expense of the external position, could lead to unsustainable exchange-rate developments.

The main policy instrument under the program would be the ceiling on net domestic assets (NDA) of the National Bank of Romania, the staff representative stated. The targets would be the floor on its net foreign assets (NFA), which was designated as a performance criterion under the program, and the exchange rate, a proxy for inflation. The floor on NFA would be the primary target. In practice, this meant that, in the event of an unexpected negative shock, the floor on the NFA would be binding after a certain point, and the exchange rate would have to adjust. The authorities would then be forced to accept a larger depreciation than originally envisaged under the program. In the event of a positive shock, such as larger-than-expected inflows, the authorities would have a choice between an appreciation of the exchange rate and/or an accumulation of reserves. In that case, the authorities were likely to opt for an accumulation of reserves, which were still at a relatively low level, particularly because of the need to protect the country's competitiveness.

In the past, the authorities had relied on increases in reserve requirements as a stabilization instrument in case of large capital inflows, the staff representative continued. To a certain extent, they would continue to rely on the greater high-reserve requirements, although—with the help of MAE—the authorities were adapting existing instruments to orient them toward more market-oriented practices. In particular, they intended to gradually shift from bilateral deposit-taking to deposit auctions, as well as to a greater use of repos and reverse repo transactions.

Achieving the inflation-rate target for end-2000 would clearly be a challenging task, which would require strong action on wages and arrears., the staff representative observed.

The nonperforming loans ratio had essentially been affected by two conflicting influences, the staff representative noted. On one hand, the share of bad loans in the system had decreased, as insolvent banks transferred their loans to the Asset Recovery Agency. On the other hand, improved prudential regulations had forced banks to acknowledge more of their bad loans than in the past, which had led to an increase in the ratio. The capital

adequacy ratio had improved overall, although this assessment was based on Romanian accounting standards, which did not necessarily measure up to international standards. More detailed data on nonperforming loans ratios and the capital adequacy requirements could be provided to Directors on a bilateral basis, the staff representative suggested.

The contrasting developments in the fiscal position of the nonbudget sector and of the central budget were largely a result of the changes in the revenue-sharing arrangements between the state budget and the local government's budgets, the staff representative continued. It was also related to the decline in the ratio of pensions expenditure to GDP.

The impact of the authorities' decision to shift resources from pensions to wages needed to be assessed against the background of the increases in the ratio of pensions to GDP in previous years, the staff representative explained. The authorities had agreed to alleviate this impact by undertaking a 'reconciliation' of pensions, which would result in larger cost of living adjustments for the lowest pensions.

The prospects for improvements in public corporate governance would, to a large extent, depend on policies to be implemented, particularly the success of the privatization program that was being undertaken in collaboration with the World Bank, the staff representative commented. This in turn would depend on sustained macroeconomic stability, which would help to enhance investor confidence.

The Fund-supported program would help Romania satisfy the Copenhagen economic criteria for European Union (E.U.) accession, the staff representative concluded. One major advantage of E.U. membership for Romania would be the eligibility for support under the E.U. Structural Fund.

Mr. Taylor disagreed with the view that inflation targeting would lead to an unsustainable exchange rate. While it might not be feasible for the Romanian authorities to set up a clear inflation targeting framework under the prevailing circumstances, it was desirable in his view. Romania needed a strong lead from the central bank, clearly identifying inflation control as an overriding objective. This would also signal to the markets that excessive wage increase would lead to increased unemployment and not much else.

Mr. Szczuka commented that, in light of the importance of fiscal adjustment for the whole program, it would have been useful to have, in the staff report, a breakdown of the main components of the general government budget. The assumption that the large increase in the central government's deficit would be compensated for by the change in the rest of the general government's deficit was questionable, particularly in view of the increasing arrears of the local authorities. While welcoming the authorities' broad consensus on a medium-term economic framework geared to E.U. accession, he stressed the importance of ensuring its consistency with the objectives of the Fund program.

The staff representative from European II Department noted that the medium-term framework had been one of the conditions for progress on accession negotiations between the E.U. and Romania. Progress would also critically depend on successful implementation of

commitments under the Stand-By Arrangement and in the context of the World Bank reform program. The strategy document had been necessarily general, as the authorities had to elicit support from the trade unions and all political parties. The European Commission had requested the preparation of a more specific action plan, which would help the Commission in assessing the progress toward fulfillment of the accession requirements. The staffs of the European Commission, the World Bank, and the Fund had all had an opportunity to review and comment on the draft.

Mr. Vittas made the following statement:

At first sight, Romania does not seem to have done particularly well under the current Fund-supported adjustment program. For one thing, several of the agreed performance criteria, many relating to significant quantitative policy targets, have not been observed. In addition, the short-term objective of the program with respect to inflation has been missed by a significant margin; and the downward adjustment in wages and the real exchange rate has been much smaller than programmed.

Closer scrutiny of the information provided in the staff report, however, makes it clear that the record is much more positive than first impressions would indicate.

First, external adjustment—which was the most important short-term objective of the Stand-By Arrangement—was, in 1999, much larger than targeted. A financial crisis was averted, the current account deficit was lowered dramatically, and international reserves were rebuilt.

Second, the fiscal position improved markedly in 1999. Indeed, the improvement can be characterized as impressive, considering that economic activity was much weaker than programmed and that wage pressures in the public sector turned out to be much stronger than envisaged under the program.

Third, the failure to fully meet performance criteria and to achieve the inflation objective of the program can only partly be attributed to policy slippage. A significant shortfall in external financing, for which it would be unfair to put the main blame on the authorities, also played a major role.

Fourth, good progress was made in restructuring the banking system and privatizing state enterprises.

Finally, strong corrective action was taken over the past several months to offset policy slippage and keep the program broadly on track.

Overall, Romania has made satisfactory progress in reducing macroeconomic balances and pursuing structural reform. Accordingly, like

other speakers, I am prepared to support the authorities' request for completion of the first review under the Stand-By Arrangement and for waiving the nonobservance of performance criteria.

Looking ahead, a question that may be asked is whether it is desirable to extend the Arrangement given that Romania's balance of payments need is no longer as evident or as pressing as when the Arrangement was approved, and given also the considerable risk that the policy program for 2000 may not be fully implemented in the runup to the elections. My own view is that there are indeed good reasons for extending the Arrangement, notwithstanding the reservations that I have just outlined.

First, despite the improvement that has been observed in the recent past, Romania's external position remains fragile. Thus, a further strengthening of gross official foreign exchange reserves is desirable.

Second, the Arrangement continues to play a significant catalytic role in mobilizing other external financing flows. In particular, continuation of the Stand-By Arrangement appears to be an essential precondition for the disbursement of substantial amounts of World Bank loans

Third, extending the Arrangement will provide the authorities with the opportunity to improve on their policy implementation record, which has not been good so far. It is, of course, critical to ensure that this opportunity is not missed.

Turning now to the policy program for 2000, let me first say that I broadly agree with its objectives and design, bearing in mind of course that the initial conditions, especially as regards wage inflation, are not favorable. In particular, I support:

The proposed shift in policy priorities from external adjustment to economic growth and disinflation

The associated shift in the orientation of fiscal policy from consolidation to a broadly neutral macroeconomic stance

The increased emphasis that the program places on structural reforms including, in light of recent experience, on measures to strengthen the supervision of financial intermediaries.

However, I have a few concerns:

First, I am somewhat skeptical as to whether the objectives of the program regarding the privatization and liquidation of state-owned enterprises

can be fully met in an election year. I would welcome staff comments on this issue.

Second, I wonder whether it is realistic to expect the wage targets for public utilities and state enterprises to be strictly observed given the large wage increases already granted to other public sector employees.

Third, I agree with the staff that the objective of halving the rate of inflation during 2000 is rather ambitious. However, it is also worth pointing out that, even if fully achieved, this target will leave the rate of inflation at the end of 2000 nearly twice as high as originally intended under the program. From a medium term perspective, a faster pace of disinflation remains desirable. Like Mr. Bernes, I did wonder whether it would not be preferable to focus monetary policy more firmly on the control of inflation, and to relieve it of the burden of pursuing other objectives. After listening to the staff's comments on the points raised by Mr. Bernes, I can appreciate better the difficulties of following that route. In particular, I can see that a radical change in the monetary policy framework, e.g., to inflation targeting, may be premature, as it could result (in view of rigidities in the wage determination system) to a large real appreciation of the exchange rate that Romania can ill afford. Nevertheless, as progress is made in strengthening the external position, it should be possible to increase the weight attached to disinflation in the design of monetary policy through a progressive reduction in the rate of nominal depreciation that is taken into account in formulating the monetary program.

Finally, I would be reluctant to characterize the external position as sustainable. Undoubtedly, export performance has been very strong in the recent past. However, the reduction in the external current account deficit reflects also to a significant extent a compression of imports associated with weak economic activity. This is likely to be partially reversed when economic slack is absorbed. In my view, therefore, some further strengthening of competitiveness will be needed, over the medium term, to ensure the viability of the external position. This should preferably be achieved through productivity-enhancing structural reforms rather than through nominal exchange rate depreciation or a sustained squeeze on wage incomes.

In concluding, let me reiterate that I am encouraged by the progress the authorities have recently made in stabilizing the external position and initiating urgently-needed structural reforms. It is now crucially important to consolidate these achievements through firm adherence to the policy program for 2000 and the preparation of more far-reaching reforms for implementation in the post-election period.

Mrs. Steinbuka made the following statement:

It is unfortunate that Romania experienced turmoil in the financial sector, which was triggered by the collapse of the country's largest investment fund and pressures on the largest state-owned bank, Banca Comerciala Romana. These adverse developments again highlighted severe weaknesses in the financial sector. We hope that the authorities and the staff have had time to understand the economic and social consequences of this turmoil, and to evaluate the additional risk to the program's implementation. The current local elections have already indicated that public support for further reforms could be significantly eroded.

All in all, Romania is very far from being out of the woods yet. Serious risks remain for the program's implementation. In particular, political stability will be absolutely essential for the success of the program. The importance of a credible political environment and the authorities' strong commitment to the reforms in light of the coming elections are crucial to bring the program to a successful completion. Apart from this non-economic risk, there are several uncertainties and concerns with regard to the program's implementation. Moreover, major risks are associated with the core elements of the program: disinflation and growth.

The inflation risks remain quite high. Inflation accelerated in April following the introduction of a uniform VAT of 19 percent on utilities. Further increases in gas and electricity prices could result in higher-than-anticipated inflation. We are concerned that the wage policy would not be restrictive, and that the government would go ahead with another wage increase, as evidenced this year with regard to the striking teachers, and earlier with regard to defense and security. In this case a sizeable overshooting of inflation target would be registered again. Hence, one of the challenges facing the Romanian authorities is breaking the inflation trend, which crucially depends on the government's ability to resist further social and political pressures.

The risk of slower-than-projected growth should not be underestimated. The combination of growth-promoting and growth-restraining factors gives a mixed picture. The staff expect that growth should be driven by exports and domestic demand. However, ongoing fiscal consolidation, higher taxes and wage restraint most likely would limit growth in consumption and public spending. The recent financial turmoil could reduce confidence in the financial system. This, in turn, could negatively influence the savings-investments balance (most likely not very significantly) and, more importantly, savings and investment decisions.

The deficit target is called into question by the government's fiscal reform package. First, the tax reform measures involved significant revenue

losses. Second, with elections on the horizon, political pressures for higher public spending and increases in wages will most likely increase. The broadening of the tax base depends on nominal GDP growth, which is uncertain, and on strengthening the tax administration. However, the experience of other transition economies shows that the adjustment of the tax administration to the new tax system takes some time, particularly if a number of significant changes have been introduced as is the case for Romania. In other words, broadening the tax base on account of tax reforms could not be expected immediately. Against this background, the government runs considerable fiscal risks.

Further developments in the external sector will be affected by the real depreciation of the leu, the restructuring of industry, and increasing demand. While the first two factors should contribute to export growth, the third factor should promote an increase in imports--investment and consumer goods. Therefore, we would not exclude the current account deficit from being higher than programmed.

The financial sector continues to present particularly serious risks, as evidenced by the recent developments in the nonbanking sector of Romania. We certainly support the urgent implementation of the action plan mentioned by Mr. Wijnholds. Indeed, in order to reduce risks, the authorities should strengthen the regulatory framework and supervisory functions in the financial sector. We also welcome the National Bank of Romania's initiative to develop and bring into full operation an 'early-warning indicator' system for banking supervision. Would it be possible to apply this system to the nonbanking financial institutions?

We encourage the Romanian authorities to move ahead with the implementation of their challenging reforms. We also hope that joining the E.U. accession process will be a powerful disciplinary factor for any government that comes to power after the elections.

Mr. Taylor made the following statement:

It is a signal improvement that the Romanian economy has started moving forward following a severe economic setback, and after having been on the brink of default last year. However, it is only the initial stage of overcoming prolonged economic crisis, and strong implementation from now on by the authorities will be the only means of progressively restoring economic stability and growth.

It is in no way to belittle the efforts of staff and Mr. Wijnholds (which must have been very considerable) to say that what we seem to have here is something of a triumph of hope over experience. I do not wish to work over the many points of fragility dealt with by previous speakers, but to mention,

for a moment, the fiscal position--which Mr. Wijnholds has described as a 'reasonable compromise.' The wages position seems very problematic to me, and the continued existence of substantial arrears is quite disappointing, given the debilitating effects that arrears have on public confidence in the system. The deficit—3.5 percent of GDP—will be difficult to finance in a non-inflationary way, even before the prospect of any slippage.

The coalition government is weak, there is an election coming, the staff notes that the socialist party is expected to win the election, and the staff advised me that when it was last a government, the relationship was turbulent. The Managing Director has stressed the importance of ownership of programs. I wonder to what extent it has been possible for staff to seek reasonably widespread ownership of the program, and, in particular, what would the alternative government's position be on privatization, which is a very important part of the essential structural reforms. That is my first question.

The second question is what degree of confidence does staff have in the budgetary data? And how does fiscal management measure up in terms of our code of conduct? For example, does the fiscal data fully reconcile with the monetary data? Is there a central finance ledger, and are spending departments required to fully reconcile against it? Is all fiscal data independently audited by a professionally staffed audit office? Those are three ways by which one could gauge the quality of the fiscal data that we depend on for this program.

Mr. Xu just referred to private-sector involvement in this program. Chair, you said on a number of occasions when we have considered Romania in the past that we should be trying to 'learn on the job' in seeking private sector involvement in this program. I always felt that was fair enough as an injunction to the Board and, through the Board, to our authorities, and we have certainly tried to draw that aspect out in our reporting to my authorities. So I am wondering now how the private sector is involved in this program, as it now stands; and what we have learned from our now fairly extensive experience with this country. Perhaps Mr. Wijnholds might have a view about that, too.

Ms. Fernandez made the following statement:

At the outset, let me commend the Romanian authorities and the staff for their hard work. It has made possible the achievement of a difficult agreement on a comprehensive economic program whose timely implementation will be of the utmost importance for renewing the markets' confidence on the economy and, with it, economic growth on a sustainable basis. In fact, it is on the bases of the program's objectives, the implementation of all prior actions, and the authorities' expressed commitment to keep the program on track, that I support the proposed

decision to approve the completion of the First Review Under the Stand-By Arrangement, the extension of the Arrangement to end-February 2001, and the waivers of non-observed performance criteria.

Overall, notwithstanding Romania's recent positive economic performance and the progress attained in the structural reform of the economy, its situation remains fragile. Inflation pressures do not seem to have been reversed; there is evidence that financial discipline might have deteriorated, as indicated by an increase in the arrears accumulated by local authorities and utilities; and the episodes of financial unrest that happened to occur these past weeks are good proof of all that remains to be done. I am glad that the authorities responded so promptly to these unfortunate developments, and I welcome the steps (besides those envisaged in the program) that are being undertaken to improve financial supervision and corporate governance—as described in the latest information provided by staff.

I share the view that the designed economic program, taking due consideration of the gains achieved thus far in terms of financial stability and external adjustment, is rightly focused on the economy's most pressing challenges, namely boosting the economic activity; reducing the high inflation rate; and maintaining the reform momentum—while, obviously, trying to preserve the positive economic results that have already been attained. However, it has to be acknowledged that the program, as stated in Mr. Wijnholds' helpful statement, 'is the result of a reasonable compromise', a compromise that, in my opinion, will render its implementation a very challenging task.

The fiscal stance is the main source of concern, notably due to the pressures that can exercise the large wage increases envisaged for the budgetary sector, in an election year where the pressures for policy relaxation are, no doubt, quite strong. The increase in wages is expected to come by with employment cuts, but like previous speakers, I am of the view that this kind of measures may prove to be very difficult to implement this year. Indeed, a strong determination would be needed to overcome the risks implicit in a budget that necessarily needs to cut expenditure in order to offset the reduction in revenues that the tax reform will bring about. Moreover, the need to avoid further wage increases becomes even more important when taking into consideration their likely effects on inflation—whose reduction is one of the main objectives of the program.

On the monetary stance, I would just like to associate myself with the arguments expressed by Mr. Bernes with regard to the need to clarify the framework for conducting monetary policy and simplify its objectives in order to improve its implementation.

The structural reforms that need to be implemented to enhance the supply-side response of the economy, and the adoption of difficult decisions will also require a major effort. In the first place, the reforms in the banking sector and the necessary improvements in the regulatory and supervisory procedures continue to be ambitious, but key to remove a very important source of distortions and financial instability—as it has clearly been seen by recent developments. The privatization process constitutes a second critical element, whose pace of implementation needs to be accelerated, notwithstanding the progress already attained, as the majority of state-owned enterprises still remain under state control.

Finally, let me just emphasize that only the full implementation of the program will have the expected effects in terms of internal and external stability and growth. Every risk of setbacks, which in the short run will mainly require the resistance to the pressures of policy relaxation that are stemming from this year's general elections, have to be avoided. The authorities cannot afford to miss any of the program's performance criteria if market conditions are to be improved. Thus, I encourage them to strictly follow the implementation of the economic policies envisaged in the program, to establish a satisfactory track record of economic performance that will help the economy regain access to capital markets and make progress in the negotiations toward E.U. adhesion.

With these comments, I wish the authorities the best in their difficult endeavors.

Mr. Estrella made the following statement:

First of all, we would like to commend the Romanian authorities for the progress achieved in economic stabilization. Today the country has a clear economic policy direction with macroeconomic stability, important structural changes, fewer and lower subsidies, and a strengthened private sector.

The authorities' program would mark a major step forward in Romania's objective for financial stability and establish the basis for sustainable growth. After three years of real GDP contraction, Romania's growth prospects are expected to improve in 2000-01, based on a recovery in domestic demand, industrial production, and, most importantly, exports. Fiscal sustainability and structural reforms are seen as key for the establishment of sustained non-inflationary growth. Also, monetary policy should continue to aim at containing inflation and achieving broad exchange-rate stability.

The collapse of a major investment fund, a confidence crisis in the banking sector, and political uncertainty are, of course, matters of concern. We hope the recent run on deposits is likely to be a short-term problem rather

than a systemic challenge. The developments in Romania's financial sector over the past week have pointed to the need for a stronger financial supervision and corporate governance. Given the importance of enterprise restructuring in enhancing efficiency and financial discipline in the economy, the authorities should intensify their efforts in enforcing budget constraints on state-owned enterprises.

All in all, we want to express our support for the first review under the Stand-By Arrangement for Romania and its requests for extension of arrangement and waiver of performance criteria, and wish the authorities every success in their difficult endeavor.

The Acting Chairman advised the staff not to address the issues related to private sector involvement, as the Board would have other opportunities to discuss them separately.

The staff representative from the European I Department noted that, despite the large wage increases envisaged for the budgetary sector, the authorities were confident that they would be able to enforce the tight wage limits for the public utilities and state enterprises, because they had managed to do so, in those same sectors, in 1999. Wages in the public utilities sector remained considerably higher than in the budgetary sector. The staff, however, was concerned that a large real wage decline for the second consecutive year in the utilities and state enterprise sectors would present difficulties, particularly in view of their monopoly power in the economy.

On program ownership and the chances of policies being sustained after the elections, the staff believed that the adoption of a common medium-term economic strategy by all political parties augured well for the future, even if the strategy remained fairly general, emphasizing basic principles without entering into the details of the policy measures, the staff representative continued. After the elections, the authorities were likely to remain amenable to adopting realistic policies. The main motivation would be the desire to make progress toward E.U. accession, a widely popular objective. In addition, any government that came into power would have to rely on coalition partners, including from the current governing coalition. The staff had offered to brief the opposition, but, for the most part, they had been reluctant, probably because they wished to keep open their option to be critical of government policies during the forthcoming election campaign.

With regard to fiscal statistics, the staff was fairly confident about the reliability and accuracy of budgetary data, compiled and reconciled from various sources by the Ministry of Finance, the staff representative remarked. The staff could bilaterally provide more detail with respect to the three tests that Mr. Taylor had suggested, but, in general, in the reconciliation of the fiscal data with monetary data the staff typically managed to reduce discrepancies to reasonable levels.

The staff representative said that he could not attest to the effectiveness of any auditing office in Romania.

Mr. Wijnholds made the following concluding statement:

We are grateful for the staff's hard work with the authorities in bringing this program back to the Board. Much has occurred during the long gap between the initial phase of the program and this first review, including the unfortunate financial developments of last week. A staff technical assistance mission that was already in the field, was immediately mobilized to resolve a number of problems related to the unexpected incidents. On behalf of the authorities, I wish to thank the staff for their exceptional efforts.

It has become abundantly clear that Romania is a difficult case. However, although past experiences have not been particularly encouraging, there is still hope. One could liken the situation to an Echternacht procession, in which for every two steps taken forward, one is taken backward, but gradually, the procession moves forward.

The fact that this is an election year, is certainly relevant, but we should not make too much of it. The Prime Minister is basically a nonpolitical figure, appointed for that reason, and, as the former central bank Governor, has a clear agenda, pushing hard, even in an election year, for reform implementation. There is some speculation about his future role, after the elections, but I hope that he can be persuaded to continue playing an active part in the government in some capacity.

We should also not be overly concerned about the former President's party's current lead in the opinion polls. As Mr. Zervoudakis has indicated, this party could be quite different in the future, and it is hardly likely to rule on its own. There will be some form of coalition, tempering those of the party's tendencies that we consider undesirable.

On monetary policy, we have had an interesting discussion, which we could pursue further at some stage.

As regards the financial sector, the recent crises have revealed a number of weaknesses, particularly in the nonbank sector. However, the authorities have acted decisively, taking strong action, including the arrest of the head of the savings bank that provided a guarantee to the mutual fund, and the dismissal of a number of supervisors. The Prime Minister has been taking a strong hand in this area, so there are clear signs of breaking with the past.

Finally, whether one can consider that the private sector is involved in the program, or not depends on the definition adopted. To the extent that there have been some capital inflows, particularly in the form of foreign direct investment, one can say that there has been some private sector involvement, although we have stepped away from its concerted form, under which the government could not borrow more than US\$100 million.

I thank you for your comments. I am sure that the completion of this First Review will be a very positive signal to Bucharest, and I hope that we can come back soon, and on time, for the Second Review.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. Last year's adjustment effort has improved Romania's external position, as evidenced by the large reduction in the current account deficit, the strong rebound in exports, and the steady recovery of the foreign exchange reserves.

However, Directors emphasized that sustained and determined implementation of macroeconomic and structural policies in 2000 and beyond will be essential in laying the basis for a lasting recovery in output and decline in inflation. Any weakening of policy would likely elicit an early negative response from the market and lead to an unraveling of last year's gains. Directors strongly urged the authorities to stick to the macroeconomic policies necessary to achieve the program's objectives, as well as to proceed vigorously with structural reform, particularly in the financial sector.

Directors considered that special efforts will be required to adhere to the proposed fiscal stance. Some of the key measures supporting the fiscal position, including budgeted expenditure cuts as well as planned employment cuts in the budgetary sector, will be difficult to implement, particularly in an election year; the authorities should be resolute in countering slippages in this area. Directors also noted that tax reform measures, while desirable on efficiency grounds, could add to pressures on the budget. With wage ceilings in the budgetary sector not being uniform, nor as ambitious as economic circumstances would warrant, Directors considered it all the more important that wages in this sector be kept strictly within the budgeted allocations. Wage targets for the public utilities and large loss-making state enterprises should also be strictly observed.

Directors urged the authorities to strengthen their efforts to reduce domestic arrears, which appeared to be rising. Success on this front and in containing wages is essential to achieving the inflation target, and in improving financial discipline more generally.

Looking to budgetary prospects further ahead, Directors noted that the budget remained in sizable deficit, which would need to be reduced. Additional reform efforts will be required, particularly in the areas of the social security system and expenditure control in local authorities and the utilities.

Directors noted the need to maintain tight credit conditions consistent with the inflation target and a further build-up in foreign reserves. They

viewed the current level of the exchange rate as broadly appropriate, as indicated by the recovery in exports and the recent evolution of the indicators of external cost competitiveness. However, they considered that greater clarity in the framework and objectives of monetary policy would be helpful. Several Directors suggested that priority be given to meeting the inflation target.

Directors considered that the recent turbulence in the financial sector highlighted the need to move forcefully to improve supervision of both the bank and the nonbank financial sectors. They noted the significant steps already taken and encouraged the authorities to strengthen prudential regulations, supervision, and corporate governance. While commending the swift response to the recent collapse of certain nonbank financial institutions, Directors emphasized that the authorities should follow through on these measures expeditiously, and, with World Bank assistance, quickly undertake a comprehensive program to address structural weaknesses in the regulation and supervision of nonbank financial institutions. Directors welcomed the authorities' measures to address weaknesses in governance, which have contributed to the recent problems in the financial sector.

Directors observed that much remains to be done in the area of enterprise reform, especially since the largest and most important commercial enterprises remain under state control. They were encouraged by the marked acceleration of the privatization effort over the past 18 months, and by the progress in preparing many of the largest enterprises for privatization or liquidation, in close cooperation with the World Bank. Directors strongly urged the authorities to maintain the momentum of reform, which would inevitably require some difficult decisions.

The Acting Chairman thanked the staff for their hard work, noting that this had been a particularly arduous negotiation process, involving countless trips and infinite patience. The staff deserved to be commended for their steadfast efforts to bring the negotiations to a useful conclusion.

The Executive Board took the following decision:

1. Romania has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Romania (EBS/99/141, Sup. 2, 8/6/99), and the second paragraph of the letter dated July 26, 1999 from the Minister of Finance of Romania and the Governor of the National Bank of Romania and paragraph 43 of the memorandum attached thereto.
2. The letter dated May 16, 2000 from the Minister of Finance of Romania and the Governor of the National Bank of Romania, with its accompanying memoranda, and the supplementary letter of June 6, 2000 from the Minister of Finance and the Governor of the National Bank of Romania, shall be attached to the Stand-By

Arrangement for Romania; and the letters dated July 26, 1999, with accompanying Memorandum, and August 5, 1999 from the Minister of Finance of Romania and the Governor of the National Bank of Romania, shall be read as supplemented and modified by the letters dated May 16, 2000 and June 6, 2000.

3. Accordingly, the Stand-By Arrangement for Romania shall be modified in the following manner:

(a) Paragraph 1 shall be amended in part to read "Until February 28, 2001.";

(b) Paragraph 2(a) shall be amended after "September 15, 1999" to read:

"the equivalent of SDR 139.75 million until August 15, 2000, the equivalent of SDR 226.50 million until November 15, 2000, the equivalent of SDR 313.25 million until February 15, 2001.";

(c) The performance criteria set forth in paragraph 3(a) for June 30, 2000, September 30, 2000 and December 31, 2000 shall be as set forth in the Memorandum on Economic Policies and the Technical Memorandum attached to the letter dated May 16, 2000; and

(d) Paragraph 3(c) shall be amended after "September 14, 1999," to read:

"August 14, 2000 and November 14, 2000, after the respective reviews contemplated in the second paragraph of the letter dated May 16, 2000 and paragraph 40 of the Memorandum on Economic Policies attached thereto."

4. The Fund decides that the first review contemplated in paragraph 3(c) of the Stand-By Arrangement for Romania is completed and Romania may continue to make purchases in accordance with the provisions of the arrangement, notwithstanding the non-observance of the performance criteria set forth in paragraphs 3(a)(iii), 3(a)(iv), 3(a)(v), 3(a)(ix), 3(a)(x), and 3(b) of the arrangement. (EBS/00/87, Sup. 1, 6/6/00)

Decision No. 12210-(00/57), adopted
June 7, 2000

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/56 (6/5/00) and EBM/00/57 (6/7/00).

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 98/18 and 99/76 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/00/79 (6/2/00) and EBAM/00/80 (6/5/00), by an Advisor to Executive Director as set forth in EBAM/00/79 (6/2/00), and by an Assistant to Executive Director as set forth in EBAM/00/80 (6/5/00) is approved.

APPROVAL: April 9, 2001

SHAIENDRA J. ANJARIA
Secretary