February 12, 2003
Approval: 2/20/03

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/126

10:00 a.m., December 20, 2002

Contents

Decision Taken Since Previous Board Meeting

Executive Board Attendance

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

Executive Directors	Alternate Executive Directors
	A.S. Alazzaz
	A.A. Al-Nassar, Temporary
D. Ondo Mañe	L. Rutayisire
	N. Guetat, Temporary
	K. Kpetigo, Temporary
	C.J. Faircloth, Temporary
	P.R. Fenton, Temporary
	F. Vermaeten, Temporary
M.J. Callaghan	M. Di Maio, Temporary
F. Zurbrugg	W. Szczuka
	S. Antic, Temporary
K. Bischofberger	H. Fabig, Temporary
	F. Haupt, Temporary
P.C. Padoan	H. Vittas
	J.N. Santos, Temporary
S.M. Indrawati	I. Alowi
	C. Durayaprapan, Temporary
	T. Segara, Temporary
Y.V. Reddy	R.A. Jayatissa
	R. Gauba, Temporary
W. Kiekens	M. Marques,, Temporary
	K. Sazanov, Temporary
	B. Andersen
	A. Alber, Temporary
	S. Kropas, Temporary
N. Jacklin	A. Baukol, Temporary
	J.W. Ralyea III, Temporary
	S. Boitreaud
	M.A. Ahmed, Temporary
	G. Nadali-Ataabadi, Temporary
	S. Rouai, Temporary
A.V. Mozhin	Y. Lissovolik, Temporary
	S. Vtyurina, Temporary
	M. Beauregard
	O.E. Garner, Temporary
	M.A. Brooke
	B. Kelmanson, Temporary
	D. Merotto, Temporary
M. Portugal	R. Steiner
	V. de los Santos, Temporary
	J. Mafararikwa, Temporary
	A. Muganda, Temporary
A.S. Shaalan	S.A. Bakhache, Temporary
	Jin Z., Temporary
	Wei X., Temporary

J. de Beaufort Wijnholds

K. Yagi

Y.G. Yakusha
H. Litman, Temporary
T. Komatsuzaki, Temporary
N. Watanabe, Temporary
D. Ayala, Temporary
R. Maino, Temporary

S.J. Anjaria, Secretary
B. Esdar, Acting Secretary
A.S. Linde, Acting Secretary
Y. Chia, Assistant
M. Pedroni, Assistant
M. Schulte, Assistant

Also Present
IBRD: N.S. Gray, Europe and Central Asia Regional Office; J. Macgregor, Middle East and North African Regional Office; B. Mierau-Klein, Credit Risk Office. African Department: N. Kirmani. European I Department: A. Leipold, Deputy Director; P. Doyle, J. Fernandez-Ansola, D. Kanda, P. Lazar. External Relations Department: M. Chatah, C. Lotze, L. Mboto Fouda, P. Reynolds. Fiscal Affairs Department: C. Allard, G. Taube. International Capital Markets Department: A. Bertuch-Samuels. Legal Department: F.P. Gianviti, General Counsel; T. Laryea, Y. Liu, M. Luedersen, C. Ogada, R. Weeks-Brown. Middle Eastern Department: A. Bessaha, J. Dridi, A. Jbili, J. Toujas-Bernate, A. Toure. Policy Development and Review Department: M. Ahmed, Deputy Director; M. Allen, Deputy Director; G. Almekinders, T. Arvanitis, M. Fisher, A. Kapteyn, R. Kincaid, I. Lukonga, A. MacArthur, M. Mecagni, B. Setser. Research Department: J. Zettelmeyer. Secretary's Department: L. Hubloue, P. Ramlogan. Office of the Managing Director: R. Moghadam, S. Tiwari. Advisors to Executive Directors: B. Bossone, P. Gitton, A.R. Ismael, K. Kanagasabapathy, T. Miyoshi, P.A. Nijsse, A.A. Tombini. Assistants to Executive Directors: S. Alcaide, R. Calderon-Colin, M. Jamaluddin, C. Josz, T.-M. Kudiwu, D. Lombardi, T.P. Nguema-Affane, E. Pinto Moreira, J. Salleh, B. Siegenthaler, T. Skurzewski, A. Stuart, D.B. Waluyo, A.Y.T. Wong, Yu J.

1. DESIGN OF SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS (CONCLUSION)

Documents: The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations (EBS/02/201, 11/27/02)

Staff: Hagan, LEG; Fisher, PDR

Length: 40 minutes

The Acting Chair (Ms. Krueger) recalled that, apart from reading the summing up, the Board would also consider a proposal by management regarding the publication of the staff paper. There had been agreement during the previous Board session that copies of the staff paper should be circulated to participants in the workshop and the conference scheduled to take place in January 2003. The question that still needed to be considered concerned publication of the staff paper together with the summing up on the Fund's external website. Management had drafted a preface to the Board paper that could be posted on the website, and hoped that it would satisfy the concerns of those Directors who had thought that putting the paper on the website might suggest that there had been consensus or that the paper represented a Fund view. The proposed preface read: "This paper was prepared by Fund staff and is intended as a step toward responding to the request from the International Monetary and Financial Committee for the Fund to develop a concrete proposal for a statutory sovereign debt restructuring mechanism which could be discussed at the meeting in the spring of 2003. It provides a comprehensive discussion of the principal features of a possible statutory approach and inevitably raises a large number of complex and sometimes unfamiliar issues. In developing the proposals, the staff has benefited from extensive discussion with private market participants, restructuring practitioners and other workout specialists, academics and members of the official community. The paper reflects work in progress and is being published in order to facilitate public understanding and discussion of the proposals. As can be seen from the summing up of the discussion of the Fund's Executive Board, it does not necessarily reflect the views of the Executive Board. Indeed, in their discussion, a number of Directors underscored their wish to continue to consider a number of options for the design of the mechanism that are not favored in the paper."

Mr. Kiekens agreed to proceed as suggested by the Acting Chair, but suggested that the proposed preface should alert the reader that there were several topics on which views diverged in the Board, among which the problem of the stay was the most important one. That problem should therefore be mentioned in the preface as a particular sensitive issue.

Mr. Portugal disagreed with Mr. Kiekens and considered that the best approach would be to have the general reference proposed by the Acting Chair, and the summing up should reflect the different views. It would be useful first to hear the summing up.

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

Executive Directors welcomed the opportunity to consider further the possible features of a new Sovereign Debt Restructuring Mechanism (SDRM).

The paper discussed today is an important step in responding to the request by the International Monetary and Financial Committee (IMFC) to develop, for consideration at its meeting in April 2003, a concrete proposal for a statutory sovereign debt restructuring mechanism to be considered by the membership. The design of the mechanism has, so far, benefited considerably from consultation with market participants and members of the judicial and legal professions and of the official community. These outreach efforts will continue, and intensify, as we move forward in search of a consensus on the need for—and the design of—an SDRM. At the same time, however, many Directors stressed that the efforts to achieve a broad support from market participants, which they strongly welcomed, should not dilute the mechanism to a point that it would lose its effectiveness. Other Directors stressed the importance of market and issuer acceptance, as the SDRM aims at fostering an orderly, voluntary debt restructuring by parties to the financial transactions. Given the wide ranging and complex issues involved, the summing up of today's discussion will probably not do full justice to the wealth of views expressed on every single aspect of a possible SDRM, but let me assure Directors that these will be very carefully taken into account in the revised paper that will be prepared based on today's discussion, and that will lay the basis for a report to the IMFC.

Objectives and Guiding Principles

Most Directors reaffirmed their belief that a carefully designed debt restructuring mechanism can make an important contribution to improve the comprehensive framework for crisis resolution and the international financial architecture, more generally. The objective of the SDRM is to provide a framework that strengthens incentives for a sovereign and its creditors to reach a rapid and collaborative agreement on a restructuring of unsustainable debt in a manner that preserves the economic value of assets and facilitates a return to medium-term viability, and thereby reduces the cost of the restructuring process. To achieve this objective, the SDRM must not only address collective action problems amongst creditors, but also catalyze an early and effective dialogue and exchange of information between the debtor and its creditors. By creating greater predictability in the restructuring process, the SDRM should also be expected to improve the functioning of international capital markets—an objective which should remain a primary concern going forward. Most Directors stressed, in this regard, that the SDRM must continue to be part of a general effort to continue to strengthen the framework for crisis prevention and resolution, including the policy on exceptional access to Fund resources.

Against this background, most Directors considered the general principles, set forth in paragraph 14 of the staff paper, to be a sound basis to help guide the design of the mechanism. A concern, highlighted by many Directors and that will need to be carefully taken into account as we seek to garner support for a mechanism that minimizes interference with contractual relations, will be to ensure an incentive structure which is both effective and balanced. Directors also looked forward to a forthcoming companion paper that will address economic policy issues that arise in connection with sovereign debt restructuring. Today's discussion has allowed us to make progress on the many financial and legal design aspects of the SDRM, although on several of them the views expressed were still of a preliminary nature, and on some important aspects of the mechanism Directors insisted that, at this stage, all options under consideration should remain on the table.

Scope of the Claims to be Covered

There is broad agreement that, in cases in which a sovereign's debt burden is unsustainable, the scope of claims that may need to be restructured will likely be broad. This will help engineer a sufficient adjustment to the debt and debt service profile to create a reasonable prospect of a return to viability, and achieve sufficient inter-creditor equity to garner broad support for a restructuring. At the same time, Directors observed that the debtor may decide to exclude certain types of claims from a restructuring, in particular to limit the extent of economic and financial dislocation.

On balance, Directors considered that these objectives will probably best be achieved by identifying the range of claims that potentially could be restructured under the provisions of the SDRM, while leaving it to the debtor, in negotiation with its creditors, to determine which subset of eligible claims would need to be restructured in a particular case. Some Directors, however, preferred an approach whereby the types of claims to be included would be more specifically targeted in the provisions of the SDRM.

Directors discussed various definitional issues pertinent to delineating the scope of claims to be covered under the mechanism. These issues, as well as those related to the specific exclusion of certain types from the SDRM—which will be discussed next—raise numerous technical questions, which Directors expect to be further clarified in the course of future work. As regards the definition of what will constitute "sovereign" claims for purposes of the mechanism, most Directors agreed that the member's central government would have the option to include its own debt and, subject to the consent of the debtor in question, claims on the central bank, and public entities or subnational governments that are not subject to a domestic debt restructuring framework. The importance of well-developed domestic insolvency regimes was highlighted, in this regard. Some Directors, however, did not support extending the definition of eligible debt beyond that of the central government. In defining the nature of the claims that would be subject to the mechanism, most Directors saw merit in adopting a sufficiently broad definition—as laid out in the paper (paragraphs 49–53)—to reduce risks of circumvention through the use of a wide range of contractual techniques that could, over time, limit the utility of the mechanism.

Directors noted that including contingent liabilities in the scope of the SDRM would raise a number of difficult challenges, and generally supported further pursuit of the proposed approach that guarantees only be eligible for inclusion under the SDRM if the underlying claim is in default. With regard to contingent claims other than guarantees, debtors should be able to include such contingent claims if they have matured or, in cases where they have not matured, if it is possible to assess market value.

Directors also recognized the merits of restructuring claims, benefiting from a statutory or a contractual privilege, outside the SDRM framework. This would protect the value of these privileges, and avoid a significant interference with contractual relations, which could severely complicate the operation of the mechanism. Some Directors expressed concern that protecting the value of such privileges might increase incentives to use them in attracting finance. Some other Directors, however, saw this risk as rather low given the hesitancy of most sovereigns to take on secured debt obligations, and the mitigating role played by the negative pledge clauses in the loans extended by multilateral development banks and private creditors.

Directors supported excluding from the SDRM claims that are governed by domestic law and subject to the exclusive jurisdiction of domestic courts, as sovereigns typically have mechanisms to restructure such claims which do not give rise to collective action difficulties. Directors noted that the transparency requirements of the SDRM would serve to help ensure that the restructuring of these claims is adequately coordinated with the restructuring of claims under the mechanism. In this context, however, a few Directors expressed concern that the obligation of full information sharing, including on domestic debt, would place the debtor at a disadvantage, especially since creditors could terminate the SDRM at any time.

There was broad agreement that claims held by international financial institutions should be excluded, reflecting the unique role that these institutions play in the existing international financial system. Some Directors cautioned that conferring preferred creditor status should not be overly broad in terms of institutions covered. Directors did not yet reach a definite view on how to treat claims held by official bilateral creditors. Many Directors reiterated their view that official bilateral claims should be excluded from the SDRM but that close coordination would be needed between the Paris Club and SDRM restructurings. These Directors noted that the Paris Club has been an effective, and flexible, mechanism for restructuring official bilateral claims and mobilizing support from such creditors for members' adjustment programs. A number of other Directors, however, saw the inclusion of official bilateral creditors, albeit as a separate class, as an important element of a comprehensive effort to coordinate the restructuring of the sovereign's debt and achieve greater inter-creditor equity, or did not want to rule out this option at this stage. Taking into account these various views, the preferred course of action would appear to be to proceed, at least initially, on the basis of excluding official bilateral creditors from the SDRM, while recognizing that this will require the formulation of additional principles and procedures, to be developed jointly with private creditors and official creditors, to address coordination and sequencing issues. The staff will continue discussions with the Paris Club Secretariat about the possible modalities of coordination between the restructurings of official bilateral debt and private debt, whether outside the SDRM or within the SDRM as a separate class.

Activation

There is general agreement that the proposed mechanism is to assist members whose debt is unsustainable. The question arises, however, whether this general statement of purpose should be enforced as a condition for activation. Most Directors were of the view that the debtor should be allowed to activate the mechanism unilaterally, without third-party confirmation that the activation is justified. These Directors noted that several proposed features of the mechanism would discourage abuse of the SDRM. Furthermore, the Fund, through its policy dialogue with members, including on assessing debt sustainability, as well as through the exercise of its financial powers, can indirectly influence a member's decision to activate the mechanism. Some Directors, however, suggested to explore further whether a third party—possibly the Fund—could provide independent confirmation of a member's representation of unsustainability, including to ensure the public good character of decisions to activate or not activate the SDRM in a given situation. Other Directors did not wish to enhance the IMF's role. Directors looked forward to further clarification of the role of the Fund in the activation process.

Consequences of Activation

Directors saw the general features of the information, registration, and verification procedures set out in paragraphs 96–122 of the paper as a useful basis for further work. While some Directors considered it desirable to require end-investors to register their claims in order to provide creditors with all relevant information, several other Directors noted that this would involve a significant change from market practice and would not necessarily result in greater transparency. Directors encouraged the staff to continue discussions with the private sector on the appropriate design of the registration and verification procedures, including on approaches that will ensure the transparency and accountability of the process. Several Directors saw merit in exploring means by which much of the registration and verification process could be performed by private parties.

A key issue in the design of the mechanism is whether to provide a stay on creditor enforcement, either automatically upon activation or upon an affirmative vote by a qualified majority of creditors. While most creditor litigations to date have been pursued after a restructuring, the SDRM might change this dynamic and elicit a proliferation of creditor litigations upon the activation of the mechanism. To safeguard the important protection which a stay could provide to the debtor during the initial stage of a restructuring process and to ensure inter-creditor equity, many Directors saw considerable merit in keeping open, at this stage, the option of imposing an automatic stay on litigation that would remain in place for a brief period until creditors are sufficiently organized to vote on an extension. These Directors observed that such a stay would encourage early engagement of the debtor and creditors in restructuring negotiations.

Many other Directors, however, recognized that an automatic stay would constitute a significant, and possibly unnecessary, erosion of contractual rights. These Directors viewed the use of the so-called "hotchpot" provision as a workable alternative that would discourage litigation without imposing a limitation on enforcement rights. Some Directors were of the view that this rule could usefully be supplemented by a feature that would enable the Sovereign Debt Dispute Resolution Forum (SDDRF), upon the request of the debtor and the approval of a qualified majority of creditors or a representative creditors' committee, to issue an order that would stay specific enforcement actions in circumstances where such enforcement could undermine the restructuring process. Other Directors, however, cautioned that this could be an unwarranted extension of the powers of the SDDRF beyond what may be deemed necessary for an effective SDRM.

Creditor Participation: Organization, Voting, and Decisions

Directors considered that, in many cases, a representative creditors' committee could play an important role under the SDRM to address both debtor-creditor and inter-creditor issues (as described in paragraphs 157–161), although it was noted that decisions in this regard should best be left to market participants. Consistent with best practices in this area, some Directors considered it appropriate that the debtor bear the reasonable cost associated with the operation of these committees. Some other Directors, however, favored a cost-sharing formula between the debtor and creditors.

There is broad agreement that a voting threshold of 75 percent of registered claims would provide an adequate balance between the need to resolve collective action problems and the need to protect the interests of creditors. On the method by which the threshold would be calculated, most Directors expressed a preference for calculating the vote on the basis of the outstanding principal of registered claims, rather than one based on quorum rules.

Most Directors saw the establishment of a framework that would create incentives for private creditors to provide financing during the restructuring period as a useful supplement to financing provided by multilateral organizations. To induce new financing, they encouraged further exploration of the proposal that a specified amount of financing would be excluded from the restructuring if such exclusion is supported by 75 percent of outstanding principal of registered claims.

Directors generally supported the broad thrust of the features of the decision-making process relating to the final restructuring agreement, as set out in paragraphs 178–212 of the paper, including the proposal that the restructuring of privileged claims would require consent of the creditor in question; that the mechanism would not provide for mandatory classification of unsecured creditors; and that, upon activation of the SDRM, the outstanding amount of claims of unsecured creditors would be deemed to be due and payable for voting and distribution purposes. A particular point discussed by Directors related to whether the SDRM would allow the debtor to create optional creditor classes. While a number of Directors considered that this could facilitate a sustainable restructuring in certain circumstances, other Directors cautioned that, in the absence of pre-specified criteria for the creation of optional classes, the predictability of the mechanism could be hampered. In particular, it would be important to guard against the creation of optional classes that could result in unjustified discrimination of creditor groups.

Several Directors noted the complexities of having multiple debtors within the same restructuring process and emphasized the importance of designing the mechanism in a manner that would facilitate effective coordination between such multiple restructurings.

Sanctions

Several Directors commented on the proposal that the provision of false information by the sovereign during the restructuring process would constitute a breach of the member's obligations under the Articles of Agreement. While some Directors saw merit in this proposal, a number of other Directors considered that the Fund should not have a formal role in this regard. They noted that the Fund's existing financial policies, including its lending into arrears policy, would be the appropriate instrument to assess the member's good faith efforts to reach a collaborative agreement with its creditors.

Termination

The SDRM would automatically terminate upon the effectiveness of the restructuring agreement by the SDDRF. In addition, and consistent with the principle of sovereignty, the sovereign debtor could terminate the operation of the mechanism at any time, although disincentives would need to be put in place to ensure that this right is not exercised in a manner that results in an abuse of the mechanism. There is also broad support for granting creditors the right to terminate the mechanism at the end of the registration process, and the staff will further reflect on what should be the appropriate voting threshold in this regard, in light of comments by Directors on the proposal to set this threshold at 40 percent.

Sovereign Debt Dispute Resolution Forum (SDDRF)

Most Directors generally supported the considerations for establishing, through an amendment of the Articles of Agreement, an independent dispute resolution body. Other Directors questioned the practical need for the Sovereign Debt Dispute Resolution Forum (SDDRF). While Directors expressed varying views on the modalities for establishing the SDDRF, most Directors were of the view that the proposals set forth in paragraphs 230 through 244 of the paper would probably strike an appropriate balance between the desirability to keep the role of the Fund in this process as small as possible, and suggestions for a more elaborate process, including involvement of the Executive Board. While a few Directors also supported granting the SDDRF the power to terminate the operation of the mechanism when it reaches the view that continuation does not serve a constructive purpose, most Directors felt that this would constitute an unnecessary expansion in the role of the SDDRF, given other safeguards built into the mechanism. As outlined in the staff paper, the Managing Director would appoint members of the selection panel on the advice of outside professional associations and insolvency and debt restructuring experts and public or private international organizations that have developed an expertise in insolvency and debt restructuring matters, and the selection panel would be entrusted with the identification of potential candidates to the SDDRF, to be approved by the Board of Governors. Some Directors were of the view that the selection and nomination process should be subject to special voting majorities in both the Executive Board and the Board of Governors. Directors who supported the SDDRF underscored the importance of establishing professional competence and impartiality as the key criteria for the selection of SDDRF members. A few Directors also emphasized the importance of taking into consideration national diversity.

Most Directors generally supported the staff’s proposals concerning the organization and operations of the SDDRF and the legal effect of its decisions, although, in light of today’s discussion, there appears considerable emphasis on the need to limit the SDDRF’s powers to the administration of claims and the resolution of disputes. Directors agreed that the SDDRF should have no authority to challenge decisions of the Executive Board, including with regard to the adequacy of a member’s policies or the sustainability of the member's debt for purposes of Fund financial assistance. In this regard, many Directors underscored the importance of a clear delineation of powers between the SDDRF and the Executive Board.

Regarding the legal basis for the SDRM, most Directors agreed that an amendment of the Fund's Articles would provide the most appropriate vehicle for the establishment of the SDRM. A few Directors however, considered that the objectives of the SDRM fall outside of the Fund's purposes, and that it would be inappropriate to use the faculty of amending the Articles for creating the SDRM. Directors noted that the preparation of this amendment will need careful further consideration in view of the important issues that it involves for both the role of the Fund and the members' domestic legal systems. In this regard, a number of Directors called on the staff to draft a questionnaire that would usefully support the assessment by members of the implications of the SDRM for their legal systems.

Next Steps

Directors encouraged management and the staff to continue to work on the design features of the SDRM and look forward to a revised paper. They emphasized the importance of continuing to engage the private sector and sovereign issuers in the discussions about the design features of the SDRM. The upcoming conference on the SDRM to be hosted by the Fund in mid-January 2003 will be an important opportunity to make further progress in clarifying outstanding issues and building consensus on the design of the SDRM.

Mr. Boitreaud considered that the summing up reflected the Board discussion adequately, but commented on the proposed preface for publication of the staff paper on the Fund's website presented by the Acting Chair at the outset of the meeting. The issue of the general stay appeared to be the most important change in the staff report, and that would probably mark the staff paper in the perception of the public. It was therefore useful, if the preface referred to that change explicitly, as had been suggested by Mr. Kiekens. However, it was perhaps even more useful to insert the entire Paragraph 13 of the summing up in the preface to clarify that point and to facilitate the information of the public.

The Acting Chair (Ms. Krueger) suggested that a paragraph could be added to the preface to highlight some of the important issues rather than inserting the entire Paragraph 13 of the summing up.

Mr. Portugal considered it unfair to the Board discussion to highlight only one particular issue in the preface.

Mr. Padoan agreed with Mr. Boitreaud that the new version of the proposal in the staff paper would be referred to in the public debate as the "soft" version versus the "hard" version that had been discussed earlier. That shift in emphasis appeared to be the general concern that had been expressed by many Directors.

Mr. Bischofberger supported the views expressed by Mr. Boitreaud and Mr. Padoan.

The Acting Chair (Ms. Krueger) proposed to formulate an additional paragraph for the preface that accommodated Directors' concerns while avoiding specific issues and that would be circulated before being placed on the website along with the staff paper and the summing up.

2. BOSNIA AND HERZEGOVINA—REPORT ON NONCOMPLYING PURCHASE AND RECOMMENDATION FOR WAIVER OF NONOBSERVANCE OF PRIOR ACTION; AND STAND-BY ARRANGEMENT—REVIEW, AND WAIVER OF PERFORMANCE CRITERIA

Documents: Report on Noncomplying Purchase and Recommendation for Waiver of Nonobservance of a Prior Action (EBS/02/193, 11/19/02); and First Review Under the Stand-By Arrangement and Request for Waiver of Performance Criteria (EBS/02/203, 12/4/02; and Cor. 1, 12/17/02)

Staff: Doyle, EU1; Kincaid, PDR

Length: 55 minutes

Mr. Yakusha submitted the following statement:

> The authorities of Bosnia and Herzegovina (BiH) would like to thank the staff for its support and continuous policy discussions in a very critical period for the future of BiH. Although governments in both Entities and in the State have yet to be formed, the political parties that won the elections and all other stakeholders involved in economic policy-making remain committed to economic reforms. The approval by the Entities and the State of the budgets for 2003, in accordance with the staff's advice, reaffirms this commitment.
>
> Program Implementation
>
> The authorities' performance under the Stand-By Arrangement remains strong, and substantial progress has been made towards implementing the program objectives. Growth is now expected to reach 3.9 percent in 2002 compared to 2.3 percent expected under the original program, inflation remains very low, foreign investment has been accelerating, and the medium-term outlook has improved. Major quantitative and structural performance criteria and benchmarks to facilitate fiscal consolidation, strengthening fiscal management, and enhancing private sector activity have been met. The authorities also undertook the necessary corrective measures regarding the

breach of quantitative performance criteria of gross borrowing from banks for Cantons and Municipalities in the Federation and for extra budgetary Funds in the Republika Srpska (RS) to ensure that end-December 2002 targets and new targets for end-March 2003 are within reach. The occurrence of these kinds of problems in BiH highlights the need for strengthening the fiscal management system, and building a well-functioning government. Both are challenging tasks in the context of post-conflict recovery, but the authorities are addressing these issues.

The authorities strongly regret the occurrence of misreporting, which was the result of a dispute between the Entity governments and the failure of the Ministry of Treasury for BiH to disclose the delay in payment of external debt on a timely basis. The small amounts involved were paid in September 2002 and the Minister of Treasury for BiH has committed to report on the status of future external debt payments on a monthly basis. The authorities of the Entities and the State have also signed an agreement, which regulates the issue of transfers from the Entities to the State for external debt service and for administrative purposes in 2003.

The Prospect

The authorities believe that, despite the remaining challenges, the economic and reform prospects in BiH are encouraging. The Steering Board of the Peace Implementation Council recently congratulated BiH for holding free, fair, and peaceful elections on October 5, and welcomed the statements in support of reform made by the political parties, which was critical to maintain this positive outlook. The intention to integrate the economy further, both internally and into the region, is also part of the current and forthcoming authorities' agenda. Moreover, in August of this year, the authorities formally initiated WTO accession procedures and have an ambitious target to comply with the WTO requirements and become a member in early 2004.

The staff's medium-term projections also reflect a positive medium-term economic outlook. Higher growth in 2003 is now expected than what was anticipated in the original program. GDP growth is expected to further accelerate in the medium term, despite a continuous decline in reconstruction aid and total foreign aid, as reforms are being implemented to accelerate privatization and to streamline government. The current account deficit is expected to halve by 2006, driven by substantial increases in annual export growth rates. The authorities remain committed to implementing all relevant structural measures to achieve this goal, but substantial renewed efforts from the side of the donor community would also be needed. Without additional support, the authorities will have difficulties in maintaining public support for reforms.

Macroeconomic Policies

Macroeconomic policies of the authorities under the Stand-By Arrangement will continue to center on the maintenance of the currency board arrangement, further fiscal consolidation, and structural fiscal reforms.

As regards monetary policy, there is a strong consensus and support for the currency board, which has served BiH well. Inflation remains very low, confidence towards the KM is steadily increasing, and gross official reserves remain on a very comfortable level. The authorities welcome the positive safeguard assessment and have started taking steps to follow up on its recommendations. The authorities have also transferred the functions of the fiscal agent for the transactions with the IMF from the State Ministry to the Central Bank.

Fiscal consolidation remains the heart of the authorities policy efforts, which is now projected to be 1.5 percentage points of GDP stronger than programmed in 2002. This consolidation reflects the hard work of both Entities to improve revenue collection and improve expenditure management control—the RS overperformed on its revenue target, whereas the Federation government made the difficult decision to cancel the delayed expenditures contingent on better revenue performance for the rest of the year. The authorities also succeeded in their ambitious military demobilization efforts, which surely is going to warrant significant public savings in the longer term. It is also noteworthy that the authorities have stopped accumulating expenditure arrears. The authorities believe that this fiscal consolidation must continue during 2003, which is included in recently adopted budget laws for both Entities and the State. The authorities also programmed revenue and foreign financing very cautiously in order to overcome the risk of expenditure arrears.

The authorities also elaborate on their far reaching structural fiscal reform agenda in their Memorandum of Economic and Financial Policies (MEFP). In this context, the authorities have also begun their discussions to introduce the VAT. The authorities also remain committed to addressing the issue of the outstanding high stock of debt only after developing a comprehensive debt management strategy. To this end, they will continue to accumulate proceeds from privatization and succession monies in a special escrow account. There is a need for further technical assistance and goodwill the of donor community to address this problem.

Structural Reforms

The authorities are aiming their structural reform agenda at boosting private sector activity, creating jobs, increasing investment, and turning an aid dependent economy into an export-driven economy. They also intend to further improve governance and reduce the cost for starting business in BiH. Banking sector reform will proceed vigorously now that most banks have been privatized. The privatization of SMEs and acceleration of large-scale privatization and restructuring are also among the authorities' priorities. The Bankruptcy Law has been approved in the RS. The Federation is still discussing the social implications of a similar bankruptcy law, which demonstrates the authorities' seriousness in this respect.

All structural reform efforts of the authorities are reflected in the full Development Strategy of the BiH Poverty Reduction Strategy Plan (PRSP), which is in an advanced stage of preparation. Broad consultations with civil society are now largely completed and the full PRSP could be submitted to the governments and the State parliament by March, 2003.

Conclusion

Strong implementation of the program in all its aspects, including fiscal consolidation and structural reforms, should reinsure the Board that the authorities' ownership of the program is strong. Completing the first review under the Stand-By Arrangement will encourage the authorities' efforts and decisiveness in pushing the reform agenda further.

The staff representative from the European I Department (Mr. Doyle) submitted the following statement:

This statement summarizes developments and data releases since the staff report was issued. The information does not alter the staff appraisal.

Political Developments

Following the national elections on October 5, discussions on the formation of new administrations continue. Meanwhile, the caretaker administrations remain in place.

Fiscal Developments

At end-October, borrowing from banks by the Federation municipalities had declined below the end-September and end-December performance criteria ceilings. Bank borrowing by Cantons had also declined, by KM 8 million from end-September, bringing it within KM 3 million (less than half of 0.1 percentage point of BiH GDP) of the performance criteria ceilings for September and December.

Entity transfers to the State for November have been completed on schedule.

Ahead of program commitments, the Federation reconstituted an additional KM 12 million of succession monies in December, bringing total reconstitution for the year to mid-December to KM 27 million (some 0.3 percent of BiH GDP).

Budgets for 2003 which are consistent with program commitments have been approved.

In the Republika Srpska, the newly elected unicameral National Assembly approved a supplementary budget for 2002 on December 2. This allocated the stronger-than-budgeted revenues mainly to social transfers and to facilitate a reduction of bank borrowing by extra budgetary funds to below the end-December performance criteria ceiling. The Assembly approved the 2003 budget on December 9.

In the Federation, no supplementary 2002 budget was necessary. The House of Representatives (first chamber) approved the 2003 budget on December 10. As the House of Peoples (second chamber) will not be formed until next year, the High Representative, Lord Ashdown, imposed on December 16 the approved 2003 budget at the formal request of the House of Representatives.

At the State level, the House of Representatives approved the budget on December 11. The House of Peoples will not convene until next year. Leaders of political parties at the state level have committed in writing to the Managing Director to support passage of the approved budget in the upper house when the upper house is convened.

Economic Developments

Inflation and industrial production for BiH for January-October 2002 were 0.3 percent and 6 percent, respectively, over the same period the previous year, in line with the projections in the staff report. The outturns for the Entity budgets in October were also consistent with the staff report.

Relations with the International Monetary Fund

The authorities advised on December 17 that they had designated the Central Bank of Bosnia and Herzegovina as the fiscal agent for the Fund.

Mr. Brooke and Mr. Mellor submitted the following statement:

Key Points

- Triple agenda facing Bosnia: current account deficit, enterprise restructuring, and rationalizing government.
- Progress so far encouraging, but significant challenges ahead. In particular, call for rapid privatization and continued tight budgetary controls.

- The PRSP process should assist the new authorities in prioritizing expenditure.

- Misreporting is serious. Expect no repeats.

The staff eloquently sums up the triple agenda facing Bosnia, namely: reducing the current account deficit as aid flows decline; implementing deep enterprise restructuring; and rationalizing government structures without enflaming sensitivities reflected in the current arrangements. Whilst progress under this Stand-By Arrangement has been encouraging, nevertheless, it bears repeating that significant transition challenges lie ahead. We urge the new governments (when they are finalized) to build on current progress, and focus on dealing determinedly with this triple-headed challenge.

Misreporting & Non-Complying Purchase

We were concerned to read of the misreporting as spelt out in the recent “Report on Non-Complying Purchase and Recommendation for Waiver of Non-Observance of a Prior Action” (EBS/02/193). Misreporting is always a serious issue. Particularly as it appears from the authorities’ letter that (at best) the Bosnian authorities were aware ahead of the August Board discussion that they were in danger of misreporting to the Board, and that they decided to inform the IMF only after both the Board discussion and the financing had been drawn down.

While noting the seriousness of what has occurred, we agree, in light of corrective actions, to the waivers for non-observance. We note the proposed improvements in the reporting system and expect that the authorities will ensure no repeat of misreporting.

Structural Reform

We are encouraged by progress in structural reform and improvement of the business environment. But substantially more will need to be achieved in the fields of enterprise restructuring, privatization, and bureaucratic and legal reform to create the attractive business environment central to Bosnia’s economic chances. The delays in large-scale privatization and the lack of improvement of governance in those enterprises already privatized through "voucherization" are particularly disappointing in this context.

We encourage the Bosnian authorities and involved donors to progress rapidly with privatization and enterprise restructuring, particularly given the context of declining aid flows and Bosnia's high current account deficit.

Fiscal Reform

There have been pleasing improvements on the fiscal deficit, which is projected to be 1.5 percent GDP better in 2002 than programmed (4 percent GDP versus 5.5 percent GDP). This is a reflection of not just higher activity on revenue, but also strengthened administration and tighter control on spending. This is to be welcomed. However, government expenditure remains very high at 56 percent of GDP and substantive rationalization is both possible and necessary.

Some progress has been achieved in structural reform of public finances, in part involving demobilization. However, the arrival of new governments (with the ability to change the currently conservative 2003 budgets) provides a clear risk to the program. We would urge the new authorities to maintain the commitment to fiscal discipline and reform.

In addition, the authorities should utilize the PRSP process to assist them in the prioritization of expenditures with an objective of achieving sustainable growth and poverty reduction. A first draft of the PRSP has recently been circulated for comment. It is clear that if a final draft is to be prepared in the first half of 2003, a considerable amount of work still needs to be done. We would argue that the priority is not now for detailed technical refinement, but rather to build a wide ownership.

Monetary Policy

We continue to support the currency board. It has played an important and successful role in anchoring low inflation and supporting macroeconomic stability. The universal acceptance of the Convertible Mark and the significant rise in reserves are indicative of its credibility.

With these remarks, we would like to thank the staff for their work on Bosnia and wish the authorities all the best in their endeavors.

Mr. Daïri submitted the following statement:

Key Points:

- Performance under the program, thus far, has exceeded expectations and offers a strong foundation on which the new government can build on.

- Fiscal consolidation must remain the cornerstone of the adjustment effort, and the 2003 budget represents a good start along the path to fiscal sustainability.

- Given the high revenue-to-GDP ratio, fiscal sustainability will have to be driven by deep public expenditure reforms.

- A healthy and well-supervised banking system, along with a robust fiscal framework and structural reforms, serve as crucial bulwarks to the currency board arrangement.

- The poor—and deteriorating—state of profitability in the corporate sector is a matter of concern, underscoring the importance of restructuring and a step-up in the pace of large-scale privatization.

- The prevalence of poverty among working people calls for early finalization of the PRSP and its sustained implementation.

- The authorities' performance under the program and commitment to further reform should be matched by an equally strong commitment from the donor community to ensure continued public support of the reform process.

The staff report and Mr. Yakusha's clear statement present a positive description of progress under the Stand-By Arrangement program and the improved medium-term outlook. This is an assessment that we broadly share. Economic activity in 2002 is expected to exceed expectations, and fiscal adjustment has been better than programmed, thanks to a combination of vigorous tax administration and tight expenditure control. The currency board arrangement has ensured that inflation remains well under control, and fiscal and other structural reforms, including SME privatization, have advanced. To be sure, there have been slippages relative to program conditionality. However, the authorities have taken appropriate corrective action, and we have no hesitation in agreeing to the request for waiver. The authorities have regretted the occurrence of misreporting and are committed to report the status of future debt payments on a monthly basis. In view of the minor and temporary nature of the misreporting and the actions taken subsequently to preclude a reoccurrence, we agree to the recommendation for waiver of nonobservance of the prior action.

The staff report indicates that, while much has been accomplished, a "daunting triple agenda" confronts the new administration when it takes office: (i) reducing the large current account deficit; (ii) pushing ahead with enterprise restructuring; and (iii) rationalizing government structures. We agree that this agenda will present formidable challenges in implementation.

However, the authorities' good track record under the program, thus far, gives us confidence that they will be up to the task.

Against the backdrop of declining aid flows and a large current account deficit, fiscal adjustment will be critical. The provisional budget framework for 2003 represents a credible start along the path to fiscal sustainability. While the new administrations will have the opportunity to make adjustments in the budget for 2003, this will be done in consultation with the staff. In any event, we are reassured to learn that there is a good understanding among parties on the need for fiscal discipline as the centerpiece of the overall reform strategy. We support the authorities' intention to seek a domestic consensus on moving towards a VAT, and join the staff in underscoring the importance of public expenditure reform to improve its composition and efficiency. Addressing the political, legal, and logistical challenges associated with the large stock of claims on government for war-related damages and spending arrears will be important in the quest for fiscal sustainability.

We welcome the broad support within the new administration for the currency board arrangement, which has served as an effective nominal anchor and has built confidence in the monetary framework. A healthy and well-regulated banking system, along with a robust framework of fiscal and structural policies, have served as crucial bulwarks to the arrangement. On the financial system, we are pleased to learn of the authorities' intention to complete privatization of banks by end-2002, with further consolidation expected to take place in 2003 along with a strengthening of the forces of competition. We welcome the authorities' intention to examine the lending practices of the major banks against the backdrop of booming household credit to ensure that no prudential norms are being violated.

With macroeconomic policies on a tight leash, growth and job creation will have to depend on strengthening the policy environment for private investment. Although the data do not appear to be very reliable, we are concerned by the poor—and evidently deteriorating—state of profitability in the enterprise sector. This underscores the need for faster and deeper restructuring in the corporate sector and a step-up in the pace of privatization of the larger entities. We welcome the actions taken to strengthen the business environment in BiH (Box 4) and the passage of the new bankruptcy law, and hope that the authorities will address impediments to its implementation.

The BiH authorities are right to be concerned about the social implications of economic reforms and the importance of protecting the most vulnerable. Given that poverty is fairly prevalent among working people, we look forward to the articulation of the government's strategy of poverty alleviation in the full PRSP.

We agree with Mr. Yakusha that the authorities' commitment to further adjustment and reform needs to be matched with "substantial renewed efforts" on the part of the donor community if public support for reforms is to remain unwavering.

Mr. Antic made the following statement:

I thank the staff for the candid report that paints a realistic picture of the Bosnian economic and political developments, as well as the well-written statement by Mr. Yakusha. The report shows improvement in the economy, but also clearly identifies emerging risks. It is now visible that the approval of the Stand-By Arrangement has helped the country in a process of changing its development path from one driven by foreign donations and concessional lending to more self-sustained growth. High growth and declining deficits are clear signs that the country has started to implement economic policy in accordance with the new reality. However, there is no time for complacency because authorities have to foster sound economic growth and find a solution for the high current account deficit. I support the proposed decision and request for waivers, and would like to comment on two issues—the trade policy pursued by the government and current account developments.

First, I would like to stress the role of liberal trade policy that Bosnia and Herzegovina has introduced. It is encouraging to see the country as the free trade forerunner in the region. Privileged export tariffs from the European Union that the country received in trade arrangements with countries contributed successfully to the success of economic policy. Those arrangements are the main vehicle for sustained growth in the long run. However, to take full advantage of expanding markets, the authorities have to foster the private sector and design policies that stimulate exports. This is of special importance since not all instruments usually used in that area are available as means of export support.

Second, while the fiscal deficit improved, the country still has high twin deficits, with an alarming current account deficit of above 22 percent of GDP. Foreign exchange reserves declined for the first time, although the staff projected an increase. The difference in foreign reserves between program and its revision is almost $370 million, which is a significant amount. I agree with the staff that foreign reserves stay high in relation to broad money and monthly imports. However, staff comments on reasons that caused the difference are needed. Could the staff also elaborate on the consequences if the decrease in the reserves becomes a trend?

Finally, I support the agreement between Entities and Federal State that will enable servicing of the foreign debt without delays. Such an arrangement has to be used for other countries that have a similar state architecture and high foreign debt. With these remarks, I wish the authorities success in their reform process.

Mr. Alber made the following statement:

I would first like to thank the staff for a balanced report and Mr. Yakusha for his informative statement.

I was glad to read that Bosnia and Herzegovina has achieved good progress in revitalizing the economy, despite the challenging political environment. It was especially welcome to note that in many areas the progress has exceeded the staff's expectations. As I broadly agree with the staff's assessment and support the completion of the first review, I will make only a few brief remarks.

First, on the noncomplying purchase, while understanding that the misreporting did not involve substantial amounts and that corrective actions have been taken, I agree with Mr. Brooke and Mr. Mellor that misreporting is always a serious issue. In a hope that misreporting will not be repeated, I am ready to grant the waiver for the nonobservance of a prior action. I also agree with the waivers for the breaches of performance criteria. In relation to these waivers, I would like to repeat a concern raised by this chair in previous discussions on Bosnia and Herzegovina, namely, that we find it very unfortunate that there is still no single institution that is responsible for the aggregated fiscal performance of the country.

Second, I welcome the improved fiscal consolidation and the authorities' cautious attitude towards future levels of revenue and foreign financing in order to overcome the risk of expenditure arrears. At the same time, I was somewhat disappointed to read from Mr. Yakusha's statement that, I quote, "the authorities have begun their discussions to introduce the VAT." My understanding is that the main unresolved issue is whether VAT should be collected at the State level or at the level of two Entities. A similar reason for delays in VAT implementation was given during the last Article IV consultation in February this year. Could the staff comment what is the main reason why this question has not been solved during almost a year and whether there is a more clear timetable for future steps on this issue?

Third, I strongly support the authorities' liberalization policy for business entry conditions and the lowering of bureaucratic burdens. These changes will have critical importance in order to invite more local and foreign investors to start their businesses and create new jobs. While welcoming the authorities' plans to reduce the time for business registration and on-site inspector days, as described in Box 4, I would suggest the authorities to standardize these rules around the country. Different approach by the two Entities may create unnecessary confusion among investors. I also hope that the authorities will be successful in strengthening the judicial system. Otherwise, their new business supportive initiatives may not materialize in the needed increase in investment flows.

Finally, I welcome the adoption of a state-level statistics law that empowers the state level statistical agency to collect and disseminate country-wide statistics. I hope the government will provide the agency with needed resources and the quality of statistics will improve significantly.

With these remarks I wish the authorities every success.

Mr. Baukol made the following statement:

The Bosnian authorities have improved this year on their spotty track record by meeting most of their policy commitments in the Stand-By Arrangement, allowing this review to go ahead on schedule. While there were a few policy slippages that necessitate waivers, the staff and the authorities have worked quickly to put in place corrective measures. The slippages reinforce the necessity for close staff monitoring of the program, given the complexity of the issues and the multiple layers of government in Bosnia.

Significant challenges now face the new Bosnian authorities. The staff correctly highlights that the focus will be on fiscal consolidation and enterprise restructuring, both of which are needed to rein in the large current account deficit, attract investment, and put the economy on a sustainable debt path in a setting of lower aid flows. Bosnia must begin work now to create the conditions for a growing private sector, including investment climate reforms, deregulation and a renewed commitment to privatization.

Fiscal policy remains the key linchpin of the Bosnian program. With IMF and other international assistance, there have been some improvements in policy this year as enumerated in the staff report and Mr. Yakusha's statement.

The fiscal plan becomes more difficult next year. As the staff notes, rationalization of public spending is an "essential task" for the new authorities. The goal next year is to reduce current spending by 2 percent of GDP, mainly by holding pension, wages, and social spending at nominal 2002 levels. The Bosnian authorities must make the tough choices on trade-offs and rationalization of the public sector at all levels of government. This includes a new structure for veterans' benefits and key social assistance, further reductions in military expenditures, investment in public infrastructure, and above all, a reduction in multiple and duplicative layers of government. Fortunately, outside donors, particularly the World Bank, are providing significant assistance and advice, including in the area of social spending.

In the medium term, the authorities would benefit from instituting a clearer framework of fiscal relations between the State, the Federation, and the RS. This issue has been outstanding for some time.

On monetary issues, we will simply support the comments of other Directors in support of the currency board.

To boost growth and productivity, and reduce unemployment, the authorities need to move forward on policies that would encourage private investment. Of particular relevance to the IMF-supported program is the banking sector. The authorities have made significant progress in the area of bank consolidation by privatizing state banks, and additional consolidation is planned next year. While remaining banks appear well capitalized, an improvement in bank regulation is needed to strengthen banks' internal control systems. We welcome the intention to focus on this issue in the next review. We also believe there is merit in the idea of bringing the RS and Federation bank supervision agencies under one roof. And, deposit insurance is another topic that is worthy of discussion. While Bosnian action on anti-money laundering and counter terrorist finance has been impressive, more remains to be done. In particular, Bosnian authorities need to strengthen existing money-laundering enforcement to protect the banking system from criminal abuse.

Other key structural issues fall under the purview of the World Bank, as the IMF-supported program is streamlined and focused on structural areas in the fiscal arena. Progress on other structural issues will be essential if the authorities are to attract the investment needed to boost productivity and growth. We welcome the description in Appendix II that provides a discussion of the World Bank's operations in Bosnia. The World Bank's focus on governance and institution building and SME development is on target. The Bank staff indicates that privatization needs to be accelerated and steps taken to improve the business environment. We look forward to further details on the progress and obstacles in these areas in future reports.

Turning to statistical issues, the authorities have received a large amount of technical assistance on statistical issues in recent years from the Fund and other donors. But, data quality remains poor in most areas. We encourage the authorities to give this issue a higher priority, as accurate data is needed for the authorities and the staff to develop high-quality policy recommendations. We ask the Fund staff to include an assessment of the effectiveness of technical assistance in future staff reports. We also ask if the staff could comment on the status of efforts to construct a register of claims on Bosnia, such as frozen deposits and war claims.

Finally, turning to the issue of misreporting, we share the concerns of Mr. Brooke and Mellor about the timing of the misreporting episode, which raises questions about the openness of the authorities. While this is a serious issue, we concur with the staff's conclusion that the misreporting on the prior action was temporary and that corrective policy measures have been adopted. On the corrective action, we welcome the commitment to provide information to the IMF staff on a monthly basis and ask if this has already been put into practice.

Mr. Marques made the following statement:

Because a misreporting occurred in connection with transfers between entities and the state, Bosnia/Herzegovina's first purchase under the stand-by arrangement was noncompliant. The Fund rightly takes a very serious view of all misreportings affecting any aspect of its work. Accuracy of information is crucial for the Fund's reputation and credibility.

Bosnia/Herzegovina's reform program is unarguably both complex and demanding. Numerous benchmarks and milestones have been established, especially by the Bretton Woods Institutions, to guide Bosnia/Herzegovina in steering its difficult course. The progress achieved so far has been encouraging, in spite of the many political and institutional difficulties.

I agree with the staff's view of the criteria permitting a waiver, and find that the corrective action that Bosnia/Herzegovina has taken justifies the proposed decision to waive the nonobservance of the prior action. The program's implementation program was not jeopardized, and we expect the authorities to avoid any recurrence of misreporting.

Bosnia/Herzegovina's economic policies, which aim at adjusting the economy to prepare it for the decline in foreign assistance, have produced strong progress. We are encouraged to hear from Mr. Yakusha that all Bosnia/Herzegovina's political parties remain strongly committed to the reform process, even after the elections. The policy framework should continue to pursue improved fiscal prudence, maintain the currency board, and deepen the structural reforms.

While the improvement in fiscal consolidation during 2002 is a good starting point for further efforts at fiscal stabilization, it is now seven years after the ending of hostilities and Bosnia/Herzegovina has not succeeded in restoring its economy to anything near its pre-war performance, and poverty remains a serious problem. The fiscal position remains precarious at all levels of government (state, entity, canton, and municipality). The demands on public resources are still high, and meeting them is made more difficult by the slowing of economic activity.

The short-term effort at fiscal consolidation described by Mr. Yakusha in his statement is promising, assuming that successive administrations continue it. Successful implementation of the ambitious program should restructure the economy away from current expenditures and towards capital expenditures, and produce substantial savings in public spending. The new authorities will be well advised to conduct an early review of public spending. It is unfortunate that the discussions about the introduction of a VAT have made no progress.

Tax receipts account for over 60 percent of public revenues (with customs duties representing the largest item), the remainder being covered by social insurance contributions. Customs duties will cease to be an important revenue source in a few years, when Bosnia becomes part of an expanding free-trade zone in south-east Europe. Social contributions will have to be cut to ease the profit squeeze on enterprises. The efficient collection of taxes, together with a strengthened legal framework for the budget execution, will become all important.

These measures will address only a part of Bosnia/Herzegovina's fiscal situation. Sustaining growth remains the key problem, and given Bosnia/Herzegovina's continuing dependence on international assistance, sustainable growth may be an elusive goal. New ways of funding the central government budget must be found as foreign assistance dwindles.

The currency board regime has been one of the most successful elements of Bosnia/Herzegovina's economic policy, and should be continued even after the relevant provisions of the Dayton agreement expire in mid-2003. In light of Bosnia/Herzegovina's weak fiscal position, the currency board must be strictly obeyed.

The implementation of structural reforms is lagging, and major efforts are needed to get it moving again. Improving the business climate is a most urgent goal, and the authorities must focus on facilitating entry and exit, lowering administrative costs, and improving the legal framework for foreign investment. The challenge will be to integrate the Entities into a single economic unit operating under a common framework.

Considerable progress has been made in consolidating the financial system, but it is unfortunately still unable to meet the needs of the economy, whether in terms of the range of financial instruments or the amount of credit available. The main short-term goals should be completion of bank privatization, the enforcement of prudent banking regulation, and the creation of an infrastructure for capital and securities markets. Increasing the public's trust of the banking system is the key to increasing the very low level of savings.

I agree to the waiver for nonobservance of the performance criteria, and wish the authorities well in their endeavors.

Mr. de los Santos made the following statement:

The first performance review under the Stand-By Arrangement shows that the authorities were able to sustain economic growth, despite the continued severity of global economic conditions. This was possible due to improved conditions in the industrial and agricultural sectors and to a healthy internal demand steered by rising incomes and consumers' bank credit. Inflation has remained subdued under the currency board anchor. With a blend of stronger revenues, efficient tax administration, strengthening of customs, and a grip on expenditures, the authorities held down the consolidated fiscal deficit. On structural reforms, we welcome the free trade agreements, the head start of Republika Srpska (RS) on its bankruptcy law, and the independence of the banking supervisory authority. We commend the State's deposit insurance scheme, the investments promotion agency, and the oil tax harmonization effort undertaken by the Brcko district.

For 2003, economic performance should improve, while inflation is envisioned to remain stable. We commend the fiscal discipline agreement, the freezing of expenditures, and the fiscal limitations imposed on the Cantons. Despite these measures, fiscal pressure is expected to rise with the fall in corporate profitability, lower tariff revenue, lower aid flows, and the funding for the State's newly created institutions.

We are pleased with the consensus reached to maintain the present monetary framework, as well as a stable monetary policy, and we support Monetary and Exchange Affairs Department's recommendation for centralized bank supervision. We remain concerned with the problem of enforcing collateral claims and urge the creation of the collateral registry and the strengthening of the legal framework to arrest this issue, which is central to the banking system and to private sector development. We also urge approval of bankruptcy laws in the Federation, and the continuation of mutual fund investment liberalization.

On structural reforms, efforts are expected to target legal reforms, the restructuring of state-owned enterprises, and the elimination of bureaucratic burden on the establishment of business enterprises. In this vein, we concur with Mr. Brooke and Mr. Mellor's statement that these issues are crucial for a better business environment and are central to Bosnia's economic chances.

We concur with the need to improve safety nets, while prudence on pensions and veterans' benefits is essential. We call on the coming administration to persevere with the demanding agenda ahead. This chair agrees with the request for a waiver and the conclusion of the first review under the Stand-By Arrangement.

Mr. Alazzaz made the following statement:

The Bosnia and Herzegovina authorities are to be commended for their adherence to the Fund-supported adjustment and reform program. While there were some policy slippages, corrective steps have been taken. The authorities' efforts have paid off in higher than expected growth, strengthened fiscal position, and lower inflation. Therefore, I support the completion of the review and the request for waivers. Here, I will make a few comments.

In the fiscal area, I welcome the better than programmed performance. The reduction in expenditures, despite higher arrears clearance is particularly encouraging. On the revenue side, strengthened tax administration has paid off in better collection. The application of tax stamp on cigarettes in August should also strengthen revenue performance and facilitate further fiscal improvement in 2003. However, achieving the programmed deficit for 2003 will require strong efforts on the expenditure front. Therefore, it is critical to implement the agreed policies and to avoid any fiscal slippages. In this connection, I am reassured by the passage of the budget and the ongoing discussions to introduce a VAT, as noted in Mr. Yakusha's statement.

Turning to monetary and exchange rate policies, the currency board arrangement is working well and the confidence in the KM is increasing. The expected completion of bank privatization and the increase in minimum capital requirements should strengthen the banking sector over the coming years. However, the prospect of some banks being liquidated during 2003, the increased competition, and the substantial rise in household credit underscore the need for strengthening supervision and improving regulations.

Increasing employment opportunities over the medium term will require steadfast effort on the structural reforms front. In this regard, I am encouraged by the actions taken, as detailed in Box 4 to strengthen the business environment. However, the poor performance of the state enterprise sector highlights the need for speedy action to restructure this sector and advance the privatization effort. This should enhance efficiency and growth over the medium term. The ongoing efforts to advance regional trade liberalization should further strengthen competition and growth.

Finally, I can go along with the proposed decision on the noncomplying purchase in view of the staff's explanation and the authorities' actions to address the situation.

With these remarks, I wish the authorities further success.

Mr. Kpetigo made the following statement:

We thank the staff for the well-written paper that they have provided for discussion, and Mr. Yakusha for his insightful statement. We also share Mr. Brooke's and Mr. Mellor's views on the importance of the triple agenda facing Bosnia.

Bosnia and Herzegovina's economic performance in 2002 under the Stand-By Arrangement was encouraging. While the country clearly is facing a general deceleration of economic activity with the high unemployment and a large external current account deficit, there is no doubt today that the economic momentum has, however, remained strong and that significant progress has been made. Indeed, economic activity and fiscal consolidation have proceeded, has exceeded our expectations. Inflation remains very low, and fiscal and structural reform also are proceeding well. We commend the authorities for these achievements, and encourage them to keep their momentum.

In the real sector, the GDP growth for 2002, led by the booming industrial activity, as well as the harvest, is expected to attain 4 percent against a projection of 2.5 percent. Also, the fiscal deficit, buoyed by the sound tax administration and expenditure restraint, is projected to improve markedly from the programmed 5.5 percent of GDP to 4 percent of GDP.

On the fiscal policies, the prospects for 2003 and beyond look favorable, as positive developments, particularly the fiscal consolidation, and the maintenance of the currency board in 2002 are to continue. Although the authorities are well aware that the weaknesses and the negative trend in corporate profitability could hold back the recovery and worsen the current account deficit, we would like to encourage them to remain prudent while implementing macroeconomic policies. We support the authorities' measures aimed to address the decline in aid flows and uncertainty.

On the monetary and financial sector policies, we are pleased to note the broad consensus among the political parties to maintain the currency board, which constitutes an appropriate framework and shield monetary policy from the complex political environment.

As regards structural reform, the authorities should be commended for having embarked on trade liberalization and easing business entry, so as to stimulate the competition. The liberalization measures coupled with the efforts to maintain the ongoing progress in enterprise restructuring could have the authorities achieve their main objectives of increased competition, production rationalization, enhanced decision-making, and improved payments discipline.

We welcome the recently approved state level statistics law and the effort made by the authorities to collect and disseminate country-wide statistics essential for decision making. We expect that the European Union will be able to finance without delay the technical assistance and research in the program.

We support the request for waivers, and with these remarks, we wish the authorities every success.

Ms. Vtyurina made the following statement:

At the outset, I would like to address the issue of a non-complying purchase. It is indeed regrettable that the very first disbursement under the new arrangement was non-complying, and it is unfortunate that this was the second occurrence under the Fund arrangement. Although the amount was small and the problem was addressed promptly, this is still a case of misreporting. We would, nonetheless, support the recommendation by the Managing Director as we see the assessment of the issue and the actions taken appropriate. Yet, we remain perplexed about why the completion of the prior action was not checked during the five-day period allocated for ensuring such completion. In our conversation with the staff, we were told that the staff based their acceptance of the fulfillment of the prior actions on verbal assurances provided by the authorities to the resident representative office. While the authorities should be trusted with the provision of verbal assurances, I wonder why this was not supported by any firm evidence, in this case the one showing transfer of funds. Otherwise, I really do not see a point in having a five-day period rule if there is no sure way to tangibly check the completion of a prior action. As this issue does not only apply to BiH, but rather concerns a general policy on misreporting, I would welcome the Policy Development and Review Department staff's response and think that we should consider this issue within our existing policy.

Moving on to the program, it is good news that there were some important achievements of main macroeconomic parameters under the program in only four months since its initiation. Especially encouraging are a significant upward revision in growth and a reduction in the fiscal deficit. Unfortunately, some performance criteria were breached during this time, but as corrective actions were taken, we would support the waivers.

On the fiscal side, we would like to pay credit where it is rightly due, that is in the fiscal area. The budget deficit has been reduced mainly due to the improvements in tax collection, including the collection of excises, sales, and customs taxes. Yet, as Mr. Marques has pointed out, BiH will soon become part of an expanding free-trade zone in southeast Europe, and customs thus will cease to be an important source of revenue over the next few years. Given this together with daunting expenditure needs and declining foreign aid, it would be necessary to further improve tax administration so that to increase tax collection in other areas and introduce VAT. In this light, while it is important to have an ambitious tax revenue target for next year and while the projected 2 percent increase in such revenue may not seem to be as such, we see that this falls well within the past pattern and think that it is better to be realistic than too optimistic.

We share the staff's recommendation regarding a freeze on non-military and non-interest expenditures. As the staff, we see expenditure restraint as a best possible option since the tax revenue to GDP ratio is already high and some taxes are excessive. Going forward, we can only encourage the authorities to proceed with the planned expenditure reform. We welcome the approval of 2003 budgets and urge all parties involved to coordinate efficiently any potential adjustments to the three budgets.

A low level of savings placed with banks has been one of the disappointing features of BiH's post-war economic recovery, and is largely explicable by a lack of public trust in the banking system. Interestingly, the depth of the population's mistrust in banks, particularly in RS, has become ever more obvious at the end of 2001 when households exchanged Deutschmarks for euros at twice the level of deposits recorded with the banks. This is happening at the time when some important advances have been made in reforming the financial system, including almost complete privatization of state banks, increasing competition, and tightening corporate governance laws. While not mentioned in the staff paper, it was reported elsewhere that the state-level Deposit Insurance Agency was established in August and will replace the Federation Deposit Insurance Agency. At present, only a few banks in the Federation are licensed to insure deposits and none in RS, however. The establishment of the Deposit Insurance Agency should be instrumental to get the population's money from under the mattress. In regards to bank credit to enterprises, it remains low because of weak collateral and bankruptcy laws and inadequate investment projects. It would be important that strong bankruptcy laws come to life in both Entities and we hope that one such law can be passed soon in the Federation. While this is necessary for increasing investment, the social aspect of bankruptcy should not be forgotten either. We share the authorities' concern regarding social implications that bankruptcies could bring at the time when unemployment is around 40 percent, by some estimates. We urge all parties involved in the reform process to pay adequate attention to this issue.

It is presumed that the next step in reforming the financial sector would be the establishment of a state-level banking agency to replace the existing entity-level agencies charged with the licensing and oversight of the entity banks. In the meantime it would be important to maintain vigilant supervision of banks' activities. The authorities argued that prudential concerns in banks were minimal, despite booming household credit (85 percent increase) since individual loans were small and well secured. At the same time, they regard excessive the maturity mismatch between assets and liabilities and are concerned about banks' weak internal control systems. In addition, the last staff report mentioned that banks were underdeveloped, however, given limited credit expansion, liquid. Now that the lending has picked up so rapidly, are there indications that banks are becoming less liquid? In any event, vigilance should be exerted in monitoring banks' health.

Like Mr. Baukol, we would like to commend the staff for producing a high quality World Bank-Fund relations annex, support the decision, and wish the authorities success.

Mr. Maino made the following statement:

We commend the staff for the comprehensive paper prepared for today's discussion and Mr. Yakusha for his candid statement. We hope that the optimistic outlook for Bosnia and Herzegovina presented in both these documents becomes a reality in a not so distant future. The chances for this to happen are closely tied to the economic prospects in the wider Balkan region, which, in turn, are influenced by its individual countries' possibilities to become members of the European Union. The latter depends to a large extent on the degree of success in pulling together the multi-ethnic and divergent political interests present in those countries under the common objective of reaching equitable and sustainable growth. In fact, the economic viability of individual countries in the Balkan region hinges on a successful integration both at the domestic and the regional level. In this regard, the Stability Pact for Southeastern Europe, as well as other initiatives represents hopeful signs that such a broad economic integration is possible. In the same vein, it is critical to keep high the hope for these countries to integrate with the European Union, which would afford them a clear road-map for reforms, as well as political and financial incentives. In our view, more attention on the part of the staff to the relevance of these broader interactions to shape the outlook for Bosnia and Herzegovina is needed in the paper.

Regarding program implementation, we welcome the fact that growth, expected at 4 percent in 2002, and a consolidated deficit of 4 percent of GDP for this year represent a much better performance than initially projected. The breach of the ceilings on borrowings and extra-budgetary funds are being corrected and we, therefore, support the recommended waivers and completion of the first review. On the other hand, unemployment, estimated at 16 percent, or 30 percent counting discouraged workers, remain high. In addition, the current account deficit at 22 percent of GDP suggest the need for a significant adjustment in the economy, particularly given the fact that international financial assistance is projected to be substantially curtailed in the coming years, which will have broad fiscal and balance of payments implications. It is necessary, therefore, to create strong foundations for sustainable growth of GDP and employment through the credible implementation of structural and fiscal reforms, while increasing transparency and advancing the rule of law.

We welcome the progress made with privatizations, particularly regarding the banking system where most banks have already been privatized with strong participation of foreign capital. This will help build a sound financial system needed to sustain the currency board arrangement. Less clear is the progress brought about by the extensive privatization program of small- and medium-size enterprises through the voucher system, which has failed to unleash a meaningful restructuring process. Allowing mutual funds to obtain majority stakes in individual companies is presented by the staff as an effective way to advance the restructuring process. The experience with other countries does not support this expectation. We are, therefore, less hopeful than the staff regarding the impact of that change in the norms, unless a transparent capital market is in place. The staff's comments would be welcome.

In addition, the privatization of large companies has continued to lag due, only in part, to the lack of foreign investors' interest. This has also led to a delay to solving the arrears problem at the enterprise level and to the timely implementation of bankruptcy procedures, thus piling up potentially large social conflicts for the future.

Notwithstanding the good performance this year, the fiscal area presents several problems. Besides the generalized tax evasion, helped also by the different taxes and rates prevailing in the two entities and political subdivisions, the main fiscal problem is the growing external and internal debt, which at 150 percent of GDP, is clearly unsustainable. It is, therefore, necessary to restructure that debt. We welcome the plans to curtail domestic claims. It is less clear the position regarding external claims, which the authorities seem to be willing to pay in full. We wonder if inter-creditor equity problems may not surface with this policy. It is also a matter of concern that the figure on public debt above mentioned also includes a substantial amount of war-related claims, and we wonder what the precise amount of these claims is and to whom are they due. The staff's comments would be welcome.

Notwithstanding the relief that may come from a successful restructuring of the public debt, Bosnia and Herzegovina will face a tight budget constraint in the future. This will require improved revenue collection and a policy to reduce public spending, as well as increasing its efficiency. With respect to fiscal administration, the introduction of a uniform value-added tax administered by the State would mean a substantial progress in efficiency through the elimination of the country's fiscal fragmentation. The staff calls for a domestic consensus on this issue before advancing with the initiative. However, there are not suggestions from the staff as to how this consensus could be reached. In the meantime, the staff proposes to strengthen custom administration, which also suffers from the lack of unification among the Entities regarding valuation methodology, post-clearance controls, and audit procedures in general. In addition, it appears that barriers to trade between the Entities still remain. In any event, the growing trend towards regional free trade agreements will inevitably lead to a loss of importance of customs revenues in the future and a greater reliance on tax revenues, thus pointing to the importance of not delaying too long the introduction of the state-administered value-added tax referred to above. The staff's comments would be welcome.

Turning now to monetary policy issues, the currency board arrangement is one of the most important pillars of the economic policy framework encompassing both the monetary and exchange rate fronts. The arrangement has been very successful so far and the authorities have expressed their long-term commitment to the regime. However, this requires strict adherence to the concomitant rules that prohibits central bank financing to the government or to the banking system. This imposes further urgency to the need to strengthen the fiscal position. In the meantime, inflation has receded to 0.3 percent and is projected to remain at very low levels in the future. Continued fiscal consolidation and maintenance of the currency board are the cornerstones for deepening structural reforms, aimed at increasing business and consumer confidence as a precondition for investment and growth.

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

There were two questions related to developments in international reserves. The first concerns the fact that the outturn so far has been less than the staff's projections. Directors will appreciate that projections for international reserves in the context of a fixed exchange rate and an open capital account are obviously hazardous, particularly so when—as in the case of Bosnia and Herzegovina—the projections were made following sizable one-off shocks in connection with the introduction of the euro and the related swaps.

The second question concerns whether and when such trends would become of concern. The indicators that the staff monitors closely are the reserve coverage and interest rate differentials vis-à-vis the euro. The reserve coverage has increased during 2002, while interest rate differentials, in so far as we are able to measure them, have been unchanged. Therefore, there are no signs of stress yet. However, I would, nevertheless, share the opinion of the central bank governor that he would prefer it if reserves were increasing.

There was a question on the liquidity of banks, and whether it has changed during the year. The banks' liquidity has declined because excess reserves of the banking system with the central bank have decreased—that is one of the counterparts to the decline in international reserves. This is partly explained by the expansion of credit to households, which has been discussed in the staff report.

A question was also raised about the delays to the preparation for the Value-Added Tax (VAT). The key issue, at least at the moment, is the level at which the tax is administered. The reason why this issue is so sensitive is that it raises fundamental constitutional questions related to taxation, in particular, the Entities' rights to implement tax policy and tax administration. These rights are carefully guarded, particularly by the Republika Srpska (RS), and it has proven difficult to find a formula that will allow the VAT to go ahead on a unified basis, while respecting their sensitivities. There are considerable efforts in hand now, particularly led by the High Representative, Lord Ashdown, to encourage an agreement on the VAT, but I cannot provide an indication now as to when that will succeed. All I can indicate is that the staff is attempting to contribute by developing models that will address these apparently conflicting aims with regards to the VAT.

On the progress made so far to estimate the size of the domestic claims on the government, with respect to the frozen foreign currency accounts, these claims are now relatively accurately quantified at around about 35 percent of GDP. The greater unknown concerns the claims for war damages. In the RS, there are fairly good estimates of these claims, which are at about 50 percent of RS GDP. Those estimates have been made possible by the fact that the RS has passed legislation that defines, in quantitative terms, compensation for the various kinds of losses. The Federation has not passed such legislation, so while the legal right to such claims is established, it is not yet possible to estimate their financial implications. The best one can do at present is to say that because the war damages were more concentrated in the Federation than the RS, they are likely to be proportionately larger. But, at the moment, there is no more accurate information than that.

On the question on the steps taken to prevent future occurrence of misreporting in the area of transfers to the State, I can confirm that the Minister of Treasury at the State has written to the staff in mid-November and mid-December confirming that the transfers are in order.

Finally, on the question regarding the evidence that was accepted by the staff prior to the Board meeting, the authorities themselves have not since questioned the facts. Therefore, the issue of whether the evidence was in writing or verbal does not arise, as the authorities do not question the facts. On the matter of checking the evidence with the particular ministry, the staff has not encountered this kind of issue before with the Ministry concerned, which is why we accepted the assurances given us at that time. However, the staff has also recommended additional steps to strengthen program monitoring, in light of this shortfall.

Mr. Yakusha made the following concluding statement:

I thank Directors for their support, as well as for their constructive criticisms. The authorities' key objectives for this year were fiscal consolidation, strengthening institutions, and promoting private-sector activity and growth. They met these objectives with a different degree of success, but, in some respects, they managed to exceed program expectations. Nevertheless, the staff is right in the overall assessment that the economy is not yet completely self-sustainable, and substantial challenges lie ahead, as aid inflows will decline.

I would like to inform the Board that the Entities confirm their commitment to reforms, and are expected to renew their efforts in enterprise restructuring, facilitating export-led growth, and further improving government and market institutions. The international community could also help Bosnia and Herzegovina by providing better market access and additional aid, in case the external environment deteriorates. While maintaining public support is important for the eventual success of reforms, risks remain.

The Acting Chair made the following summing up:

Executive Directors welcomed Bosnia and Herzegovina's steady economic progress under the program. They noted that fiscal consolidation and economic growth has been faster than anticipated, inflation remains low, the currency board is functioning well, and structural reforms have proceeded satisfactorily. These achievements provide a strong base to address the considerable challenges that lie ahead—reducing the external current account deficit as aid flows decline, implementing deep enterprise restructuring, and rationalizing government structures.

Directors regretted that a difficulty in executing Entity transfers to the State in mid-2002 resulted in misreporting to the Fund regarding such transfers. They granted a waiver for this incident in view of the corrective actions that have been taken, but strongly advised that steps be taken to avoid such incidents in the future. Directors considered that overall program implementation remains fundamentally on track, noting that most performance criteria and structural benchmarks have been observed to date. Accordingly, they agreed to complete the review.

Directors commended the authorities' commitment to achieving fiscal sustainability. The authorities' success with fiscal consolidation, which was considerably faster than targeted, helped to contain the external current account deficit and provided added support to the currency board. Directors welcomed the military demobilizations that have taken place, noting that the significant fiscal gains from these measures will become apparent in 2003 and beyond. Looking ahead, they agreed that continued fiscal adjustment will have to be driven mostly by rationalization of expenditure.

Directors were generally satisfied with the steps taken by the caretaker administrations—and endorsed by the newly elected assemblies and leadership—to safeguard the fiscal frameworks in 2003. They welcomed the adjustments to the Republika Srpska (RS) budget for 2002, the adoption of the budget for 2003 by the RS National Assembly, the application of the Federation budget following its passage by the lower house, and the authorities' commitment to ensure early completion of parliamentary procedures in regard to the State budget following its recent approval by the lower house.

Directors noted that the incoming administrations may revise the 2003 budgets in line with their priorities. They urged that any such revisions leave unchanged the overall fiscal adjustment envisaged in the provisional budgets, both to support current account adjustment and to signal the commitment of the new administrations to continued fiscal consolidation. Furthermore, given the need to reduce the size of government, Directors strongly recommended that total consolidated spending not exceed the level envisaged in the provisional budgets.

Directors welcomed the authorities' continued adherence to the currency board, which remains an effective nominal anchor. They stressed that banking regulations should continue to be aligned with international standards, including in regard to capital adequacy and accounting rules, to ensure that the banking system remains strong. In particular, Directors emphasized the need for continued vigilance in the current environment of rapid growth of consumer credit to ensure that prudential norms are not being violated. They expressed satisfaction that the recently completed safeguards assessment was favorable.

Directors welcomed the continued momentum of structural reforms, especially the steps taken to improve tax administration and treasury functions as well as to prepare the way for a restructuring of domestic claims on government. They noted that bank and small- and medium-scale enterprise privatization was all but completed, steps to improve the business environment have proceeded with World Bank support, trade liberalization is advancing through regional free trade area agreements and planned accession to the World Trade Organization, and the legal basis for the preparation of macroeconomic statistics has been strengthened. Directors urged the authorities to accelerate progress in the area of large-scale privatization. They also underscored the need for higher quality macroeconomic statistics, notably in the fiscal and balance of payments areas.

Looking ahead, Directors noted that Bosnia and Herzegovina will face major challenges to accelerate economic growth and combat high unemployment, while reducing the external current account deficit, in the context of declining reconstruction aid inflows. Accordingly, they welcomed the authorities' continued commitment to their program supported by the Stand-By Arrangement, and stressed the importance of fostering export growth through a comprehensive agenda of structural reforms. This agenda should include more ambitious privatization and public enterprise restructuring, institutional and legal reforms to create an attractive business environment, improved bankruptcy procedures, strengthened domestic credit markets, reforms to corporate governance, and further trade liberalization. It should be supported by wage restraint and continued fiscal prudence. Directors noted that the new administrations have inherited a much improved economic framework from which to set out to meet these challenges, and that ambitious reform efforts would attract the continued support of the international community.

Directors considered that further work on the development of an interim Poverty Reduction Strategy Paper would best be advanced in the context of a strong macroeconomic policy environment, and encouraged initiatives to build a wide ownership of policies targeting poverty on that basis.

The Executive Board took the following decisions:

Report on Noncomplying Purchase and Recommendation for Waiver of Nonobservance of Prior Action

The Fund notes the report of the Managing Director set forth in EBS/02/193, 11/19/02, on the noncomplying purchase made by Bosnia and Herzegovina on August 7,2002 under the Stand-By Arrangement for Bosnia and Herzegovina (EBS/02/91, Sup. 1, 8/5/02) and decides to waive the nonobservance of the first of the specified prior actions set forth in Table 2 of the Memorandum on Economic and Financial Policies attached to the letter from the Chair of the Council of Ministers of Bosnia and Herzegovina, the Prime Minister of the Federation of Bosnia and Herzegovina, the Prime Minister of the Republika Srpska, the Minister of Treasury of BiH Institutions Bosnia and Herzegovina, the Minister of Finance of the Federation of Bosnia and Herzegovina, the Minister of Finance of the Republika Srpska, and the

Governor of the Central Bank of Bosnia and Herzegovina dated May 31, 2002, on the condition that the information provided by Bosnia and Herzegovina on the implementation of this measure is accurate. (EBS/02/193, 11/19/02)

Decision No. 12914-(02/126), adopted
December 20, 2002

Stand-By Arrangement—Review, and Waiver of Performance Criteria

1. Bosnia and Herzegovina has consulted with the Fund in accordance with paragraph 3(d) of the Stand-By Arrangement for Bosnia and Herzegovina (EBS/02/91, Sup. 1, 8/5/02) and paragraph 3 of the letter of the Chair of the Council of Ministers of Bosnia i Herzegovina, the Prime Minister of the Federation of Bosnia and Herzegovina, the Prime Minister of the Republika Srpska, the Minister of Treasury of BiH Institutions Bosnia and Herzegovina, the Minister of Finance of the Federation of Bosnia and Herzegovina, the Minister of Finance of the Republika Srpska, and the Governor of the Central Bank of Bosnia and Herzegovina dated May 31, 2002.

2. The letter of the Chair of the Council of Ministers of Bosnia and Herzegovina, the Prime Minister of the Federation of Bosnia and Herzegovina, the Prime Minister of the Republika Srpska, the Minister of Treasury of BiH Institutions Bosnia and Herzegovina, the Acting Minister of Finance of the Federation of Bosnia and Herzegovina, the Minister of Finance of the Republika Srpska, and the Governor of the Central Bank of Bosnia and Herzegovina dated December 4, 2002, with its attached Supplementary Memorandum on Economic and Financial Policies ("SMEFP") and Supplementary Technical Memorandum of Understanding ("Supplementary TMU"), shall be attached to the Stand-By Arrangement for Bosnia and Herzegovina, and the letter of the Chair of the Council of Ministers of Bosnia i Herzegovina, the Prime Minister of the Federation of Bosnia and Herzegovina, the Prime Minister of the Republika Srpska, the Minister of Treasury of BiH Institutions Bosnia and Herzegovina, the Minister of Finance of the Federation of Bosnia and Herzegovina, the Minister of Finance of the Republika Srpska, and the Governor of the Central Bank of Bosnia and Herzegovina dated May 31, 2002, together with its respective attachments, shall be read as supplemented and modified by the letter dated December 4, 2002, together with its attachments.

3. Accordingly, the Stand-By Arrangement for Bosnia and Herzegovina shall be amended as follows:

(a) The words "or the public sector" in paragraph 3(a)(iii) shall be deleted;

(b) the performance criterion set forth in paragraph 3(a)(iv) shall be replaced with the following:

"(iv) the ceiling on the contracting or guaranteeing of new external debt by the general government with an original maturity of up to and including one year";

(c) the performance criterion set forth in paragraph 3(b) shall be replaced with the following:

"(b) if at any time during the period of the arrangement, the limit on external payments arrears specified in Table 4 of the letter dated December 4, 2002 and further specified in section I.C of the Supplementary TMU is not observed; or"; and

d) the quantitative performance criteria referred to in paragraph 3(a)(i) through 3(a)(iv) of the Stand-By Arrangement for March 31, 2003 shall be as specified in Table 4 attached to the letter dated December 4, 2002 and further specified in the Supplementary TMU.

4. The Fund decides that the first review contemplated in paragraph 3(d) of the Stand-By Arrangement for Bosnia and Herzegovina is completed and that Bosnia and Herzegovina may make purchases under the Stand-By Arrangement, notwithstanding the nonobservance of the end-September 2002 quantitative performance criteria on the ceiling on credit of the banking system to the RS extra-budgetary funds, the Federation cantons, and the Federation municipalities specified in paragraph 3(a)(i) of the arrangement on the condition that the information provided by Bosnia and Herzegovina on performance under these criteria is accurate. (EBS/02/203, 12/4/02)

Decision No. 12915-(02/126), adopted
December 20, 2002

3. DJIBOUTI—REPORT ON NONCOMPLYING DISBURSEMENT AND RECOMMENDATION FOR CORRECTIVE ACTION; POVERTY REDUCTION AND GROWTH FACILITY—REVIEW, AND WAIVER OF PERFORMANCE CRITERIA; AND POVERTY REDUCTION STRATEGY PAPER PREPARATION STATUS REPORT AND JOINT STAFF ASSESSMENT

Documents: Report on Noncomplying Disbursement and Recommendation for Corrective Action (EBS/02/208, 12/9/02); Third Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Non-Observance of Performance Criteria (EBS/02/212, 12/11/02); Poverty Reduction Strategy

Paper Preparation Status Report (EBD/02/161, 12/12/02); and Poverty Reduction Strategy Paper Preparation Status Report—Joint Staff Assessment (EBD/02/162, 12/12/02)

Staff: Toujas-Bernate; MED; Ahmed, PDR

Length: 1 hour, 5 minutes

Mr. Ondo Mañe submitted the following statement:

Since the start of the PRGF-supported program, in 1999, Djibouti has made encouraging progress in the reinforcement of fiscal discipline and transparency, and the implementation of a number of important structural reform measures. While real GDP has not grown as expected, inflation has been kept around 2 percent, financial imbalances have declined, and domestic arrears reduced.

In assessing Djibouti's performance under the program, it is important to recognize the limited institutional capacity of the country, as well as its lack of trained personnel, which at times have delayed the implementation of policy measures. Moreover, the country has also had to deal with a number of exogenous shocks, such as the instability in the region, drought, the inflows of refugees, and a protracted domestic peace process. Although there have been some delays in the implementation of some measures, which have caused some performance criteria to be missed, the authorities have maintained their adjustment efforts, which have helped to improve the overall financial situation of the country. Nevertheless, efforts will be required to diversify the economy and improve per capita income. It is the intention of my authorities to continue these efforts over the medium to long term with the support of the international community.

Performance Under the Program

Economic growth in 2001 was helped by activity in the port, and the construction sector, but remained weak. Real output increased by less than 2 percent, but inflation remained subdued. In 2002, economic activity has picked up due to increased port activity and the presence of large contingent of military forces involved in the fight against international terrorism. Financial imbalances have also improved.

Fiscal Sector Policies and Reforms

In the fiscal area, although revenue to GDP has been generally high in Djibouti, shortfall occurred in 2001, mainly due to delays in setting up the real property database, and new procedures to collect tax arrears. Revenue from domestic consumption tax, petroleum products and alcohol were also lower than projected, and there were no transfer from the central bank. Control was maintained over expenditure. However, the budgetary domestic balance registered a deficit of 0.3 percent of GDP, compared to a programmed surplus of 0.9 percent of GDP. This shortfall in revenue, as well as shortfall in external disbursements were the main cause for the missing of some of the end-December 2001 performance criteria. After taking corrective measures, and the strict implementation of the treasury cash management plan, which was included in the finance law for 2002, revenue performance improved in the first half of 2002, and the budgetary domestic balance showed a surplus as compared to a programmed deficit. Moreover, the stock of domestic arrears was reduced during that period. However, the envisaged decline in the wage bill was not achieved as the retirement of 850 civil servants took longer than expected, and there was a slowdown in the demobilization process, so that the related performance criteria were missed.

In October 2002, an amended budget was approved and it reallocated resources to the social sectors, in particular to rehabilitate schools and healthcare facilities, and to improve access to water in certain regions of the country. Preliminary data indicate that the fiscal objectives for end-2002 will be met, and that the budget will register a surplus of 0.4 percent of GDP in 2002. For 2003, the prudent fiscal stance will be maintained, and with a projected decline in spending, a fiscal surplus of 1.3 percent of GDP is projected.

A major concern of my authorities has been the large stock of domestic arrears. With the assistance of the European Union and the World Bank, a survey of outstanding domestic arrears has been concluded. Claims have been audited and a plan to restructure and to repay over 10 years the entire stock of domestic budgetary arrears has been put into place. A priority list has also been established and it is based on the need of creditors and their role in improving economic activity. The authorities will issue promissory notes to provide a legal foundation for the validated claims. A steering committee has also been established to implement the plan for which my authorities are appealing for external assistance.

The Djibouti authorities have also implemented a number of important reforms in the fiscal area. The tax and customs administrations have been modernized and streamlined, with Fund technical assistance, and public expenditure management has been strengthened. The income tax system has been revamped with a number of steps taken that will reduce the number of delinquent tax payers, and improve its efficiency. A plan has been adopted to reorganize the ministry of finance with a view to improving its functioning and the preparation of the budget as well as its control and monitoring. The plan also includes the moving of the budget commitment process toward line ministries. Moreover, all government accounts held with commercial banks have been transferred to the central bank as of August of this year. These measures should help to strengthen the budgetary process and make it more transparent.

The reform of the pension plan has been completed, and the government has also created a National Social Security Council with the responsibility of implementing the reform and the management of the pension funds.

Financial Sector

Reflecting weaker economic activity and uncertainties about the economic outlook situation, as well as an increase in nonperforming loans, domestic credit to the private sector has experienced a decline in 2001 and also in the first part of 2002. Broad money increased, reflecting higher demand deposits with commercial banks, which experienced an increase in net foreign assets.

With its currency board, Djibouti's financial sector has played a key role in the region, and the authorities have given a key priority to maintaining the integrity and effectiveness of the banking sector. In this context, the Central Bank of Djibouti (BCD) has taken further steps to strengthen banking supervision, including onsite inspection. This is being effected with assistance from the Bank of France, which is helping to train its personnel. Moreover, in August, the BCD has hired new external auditors to audit its accounts, and it has taken steps to institutionalize the external audit mechanism, so that the BCD accounts will be audited annually. In addition, in September 2002, a new law has been adopted which will strengthen the legal framework to combat money laundering, and the financing of international terrorism.

External Sector

The external current account deficit fell to 4.3 percent of GDP, in 2001, mainly on account of lower import, but is likely to increase in 2002. The overall balance of payments surplus, however, increased in 2001 and is projected to increase further in 2002, reflecting higher external project assistance and service receipts from foreign military and transport services.

The authorities have made progress in resolving pending external debt issues, although with some delays. In June 2002, they settled the arrears to French hospitals. In November, bilateral rescheduling agreement was signed with one Paris Club creditor, and the authorities expect to conclude bilateral agreements with two other creditors.

However, in view of the weaknesses that became evident recently regarding external debt management, the authorities with the assistance of the

World Bank and UNCTAD have put in place a new debt management system that will help them to better track all loans and prevent any misreporting error.

Moreover, the authorities, with external assistance, have proceeded with an assessment of the infrastructure and processing capabilities of external trade data, and will install a new system that will help to expedite the preparation and dissemination of external trade data, thus eliminating a cause of delays in the provision of those data to the staff.

Other Structural Reforms

The authorities remain committed to the privatization of the remaining enterprises, and they are working closely with the World Bank to develop a privatization strategy and to prepare the enterprises for financial audits. In the meantime, the management of the international airport was privatized in June 2002.

On the labor code, the consultation process is taking longer than expected, but recent agreements with the unions have made it possible to expedite the process.

Following tripartite discussions, the authorities expect to submit the revised labor code to the National Assembly for approval.

On the investment code, this is under review, and the authorities agree that it should be streamlined and rationalized. They intend also to centralize the authority that will grant and manage it. However, delays have occurred with respect of the Commerce Code, due to the fact that Djibouti has joined the COMESA, and is redrafting the code which has been prepared to harmonize with OHADA.

In the context of improving economic growth, and reducing poverty, the authorities are working closely with external investors to develop a second and larger port in Djibouti which would be able to accommodate the projected increase in shipments. When completed, it should lead to the creation of a large number of employment opportunities as well to higher economic growth. The authorities have also created an Export Processing Zone which they expect will attract investors and thus help create new employment opportunities. These, together with the other structural reforms being undertaken are expected to contribute to an increase in economic growth over the medium term.

Poverty Reduction Strategy Paper

Djibouti's I-PRSP was presented to the Board in November 2001. Based on the comments received, including from the Fund and World Bank staff, my authorities began work on the full PRSP. The poverty reduction strategy is based on a long-term view of Djibouti, as well as on the analysis of the national poverty situation and its causes. The process of preparing the PRSP has involved the members of the government at the highest level, civil society and the private sector. Several seminars and workshops have been held and were well attended. On the basis of these consultation, the sectoral strategies have been developed. The macroeconomic framework is under preparation. The main difficulty is how to strike the right balance between the limited budgetary resources and the need for more spending to alleviate poverty. The authorities are continuing work on the full PRSP and expect to submit it to the staff in the near future.

Noncomplying Disbursement

As regards this issue, my Djibouti authorities would like to explain that the overdue obligation to the Arab Monetary Fund in the amount of SDR 59,214 was due to an oversight in the reporting system, caused by the lack of coordination between the 4 institutions involved in external debt management, and weak administrative capacity and confusion regarding the role of the BCD in settling external obligations through an accelerated procedure. As noted in the Managing Director’s report, the error was caught by the BCD which promptly informed the Minister. However, in the meantime the authorities had already sent a letter to the Fund indicating that all arrears due to multilateral creditors had been cleared. This was a honest mistake on their part and at no time was there any intention to transmit wrong data. My authorities would like to reiterate that the honoring of external obligations has been a top priority for them, even when they were faced with severe financial problems.

The situation has been regularized, and corrective actions have been taken to strengthen compilation and management of the external debt database and to simplify budgetary procedures to better monitor and execute spending on external debt. Moreover, as explained above, a new directorate of external financing has been created which has the authority to centralize management and monitoring of government and government-guaranteed external debt. In the circumstance, my Djibouti authorities are requesting a waiver for the noncomplying disbursement.

Conclusion

My Djibouti authorities recognize that there have been delays in the implementation of the program and that some performance criteria for the periods under review were missed, due mainly to capacity and institutional constraints. However, they would like to note that they have taken corrective actions, and that strong efforts were made in many areas, as described above. In particular they would draw attention to the range of structural reforms already undertaken, and those underway, which attest to their commitment to the adjustment process. They are, therefore, requesting waivers for the missed performance criteria, and the support of the Board for the proposed decisions. My authorities would also like to reiterate their commitment to continue the reforms with the assistance of the international community. While financial assistance will be important, they would like to point out that technical assistance will also be critical to address the constraints that Djibouti faces.

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

Djibouti's economic performance under the PRGF-supported program has been mixed, particularly when seen in the context of the implementation of the various elements of the reform agenda as can be seen from the large number of waivers requested under this and the previous reviews. However, a broader look at developments in the economy shows that, notwithstanding this mixed performance, Djibouti has experienced welcome progress in a number of important areas. Specifically, while the growth of real per capita GDP remains negative, the contraction has dropped from over 6 percent in 1996 to under 1 percent for this year, close to achieving an actual increase for the first time in many years. Throughout this period, the authorities managed to maintain a stable financial environment while steadily settling domestic arrears. The balance of payments has also registered a marked improvement in recent years moving to an overall surplus in both 2001 and 2002.

These developments are a testimony to the authorities' resolve in advancing the reform agenda, albeit not consistently, in a rather difficult environment as well as the benefits of the close cooperation that has developed between Djibouti and the Fund. For the period ahead, we look forward for the Fund's continued engagement in Djibouti and hope that a mutually agreeable program can be designed to help Djibouti build on the progress achieved thus far and create the appropriate conditions for better investment and growth performance.

In spite of the aforementioned progress, a number of weaknesses, that seem to be limiting the extent to which the economy can adjust and grow, remain. While problems span a number of sectors in the economy, the structure of the budget is seriously constraining the room for maneuvering available to the authorities. Given the high revenue-to-GDP ratio, the scope for further revenue mobilization is almost non-existent. In fact, this ratio has not changed significantly over the past few years, suggesting that indeed, further fiscal adjustment cannot realistically be generated through revenue increases. This is not to say that there is no need or no point in continuing the reform effort to modernize the tax system. In fact, we very much welcome the progress achieved in improving tax collection and modernizing the tax and customs administration which has led to better revenue performance this year. On this issue of strengthening the tax and customs administration, we believe that the authorities should ensure that additional reforms planned in this area are consistent with any future plans to modify the tax system and move to indirect taxation.

In light of the limited potential for increasing revenue, expenditure rationalization and reduction takes on added importance. Significant progress has taken place in the past year in strengthening budget management through the implementation of the treasury cash management plan. Furthermore, the adoption of a strategy to clear the stock of domestic arrears is encouraging and we hope it will be effectively executed. One area where progress seems to be lacking is the wage bill. Although declining in recent years, at around 14 percent of GDP, the wage bill represents a significant burden on the budget and should therefore be a main target for adjustment, particularly given the high financing requirements of the social sectors and the need to appropriate resources for improving the country's infrastructure. With regard to spending on priority sectors, we welcome the revision in the 2002 budget, which aimed at increasing allocation for these sectors, thanks in large part to the above-mentioned administrative improvements on both sides of the budget. We hope that these sectors will continue to receive adequate financial resources in the period ahead in the context of a transparent and predictable framework aimed at targeting specific poverty reducing programs.

With regard to exchange rate policy, in the past we have been reluctant to support an exchange rate adjustment given that the benefits of such an action are uncertain, while the risks are high. While we still are reluctant to take this road, as we said above, the options for adjustment available for the authorities have been shrinking recently. Clearly, the most appropriate course of action is still to first reduce the fiscal deficit primarily through wage and salary cuts, and to move forward with structural reforms to boost the economy's growth potential. At the same time, it would be useful to consider an exchange rate adjustment in case other options do not materialize or are not feasible. Here, it is worth noting that the effect of an exchange rate adjustment would be tantamount to an across the board reduction in public sector wages. Therefore, unless pressures for wage increases in the wake of a devaluation are resisted, an outright wage cut would be a preferable path to adjustment than an exchange rate action.

Of course, considering this course of action would give rise to a whole host of issues that need to be addressed a priori. Among them is the question of the subsequent choice of an exchange rate system. In particular, would a currency board remain the best option for Djibouti, and given Djibouti trade partners, what currency or currencies should the new rate be pegged to, if a fixed system is chosen? Is a more flexible system more appropriate and, if so, what anchor should the authorities use to control inflation? In addition, given the potentially serious repercussions of an exchange rate adjustment, the authorities have to have in place a strengthened social safety net as well as appropriate vehicles to allow the private sector to generate adequate employment opportunities.

On monetary and credit developments, we believe the authorities should turn their attention to the issue of low bank credit to the private sector. In this regard, it should be noted that domestic credit to the private sector declined by 14.3 percent in 2001 and continued on this trend until September of this year. This decline is taking place at a time when deposits in the banking system have been on the rise, thus giving banks ample resources to intermediate. While there could be many reasons for this phenomenon that should perhaps be investigated, limited investment opportunities in the country may very well be an underlying reason. This, in our view, brings into focus the necessity of improving the investment climate in general and to advance the work on the investment, labor, and commerce codes with a view to reducing the cost of doing business in the country and attracting investment.

Finally, on the issue of the non-complying purchase, we thank the Managing Director for presenting the case in a clear and concise way. We agree that the unfortunate inaccuracy in the November 21, 2001 letter represents a misreporting case that gives rise to a non-complying disbursement under the PRGF-supported program. In light of the minor scale of the deviation, which was settled as the authorities made the appropriate payment to the Arab Monetary Fund, and the corrective action taken subsequently to improve the monitoring and settlement of external debt, we support the MD's recommendation to grant a waiver in this regard.

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

Mr. Daïri submitted the following statement:

Key Points

We support the authorities' request for waivers and completion of the third review under the PRGF-supported program, as well as the proposed decision on noncomplying disbursement;

Preserving macroeconomic stability, while covering the cost of additional priority social programs, argues for continued fiscal consolidation;

The currency board arrangement has contributed to low inflation, but faster structural reform implementation is required to restore external competitiveness;

Revision of the banking law and the central bank statutes as well as strengthening banking supervision remain a priority;

We welcome the authorities' commitment to a prudent external debt management and to a further enhancement of its institutional framework;

The authorities should seek further donors' support and adopt a more realistic timetable in their commendable effort to finalize the full PRSP.

We thank the staff for a well-written report and Mr. Ondo Mañe for his informative statement. Notwithstanding limited institutional capacity, Djibouti has made encouraging progress under the third year of the PRGF arrangement. In 2002, growth, albeit still modest, is projected to be higher than programmed, driven by a buoyant services sector, in a historically low-inflation environment. With domestic budgetary balance shifting into a surplus, the fiscal position strengthened, reflecting implementation of a broad budgetary reform agenda and a treasury cash management plan. Settlement of a long-standing dispute with France signaled progress in resolving pending external debt issues. There were also positive developments on the structural front with the implementation of the pension fund reform, additional steps in fiscal and financial sector reforms, and the privatization of airport management. We concur with the thrust of the staff appraisal. In view of the authorities' renewed commitment to adjustment and reform and implementation of prior actions, we support their request for waivers and completion of the third review under the PRGF-supported program. Moreover, while the recent misreporting incident is regrettable, it does not warrant any remedial action, given its minor and temporary nature, as well as subsequent steps taken by the authorities to prevent its reoccurrence. We, therefore, support the proposed decision.

Preserving medium-term fiscal sustainability, while allocating higher expenditures on priority social programs, hinges on sustained fiscal consolidation. We welcome the strengthened revenue collection as well as the successful implementation of the new income tax, and underscore the need to modernize tax administration, in line with the FAD recommendations, to prepare for the introduction of a VAT in the near future. However, given an already high revenue-to-GDP ratio, the burden of adjustment should be on expenditure reduction and rationalization. We welcome the authorities' commitment to a continued prudent fiscal stance in 2003 by targeting a higher domestic budgetary surplus reflecting essentially a lower wage bill, while at the same time allocating more resources to spending in priority social sectors. Transferring all government accounts to the central bank (BCD), reorganizing the ministry of finance, and moving the budget commitment process toward line ministries promise to strengthen the budgetary process and make it more transparent. Given that the domestic arrears weigh heavily on the economy, we welcome completion of their audit and the adoption of a plan for their clearance. The authorities are well advised to implement the plan decisively and with full transparency, and to seek external donors' assistance in the broader context of their poverty reduction strategy.

Djibouti's currency board arrangement has helped keep inflation at low levels. While the authorities' preference is to rely on broad-based structural reforms and fiscal discipline for raising competitiveness, implementation of the needed reforms should be accelerated, especially in view of the recent real exchange rate appreciation. In any case, exchange rate developments and competitiveness indication need to be kept under close review. On the banking sector, we welcome the adoption of an anti-money laundering law and the initiation of an external audit of the BCD accounts. To further protect the integrity and effectiveness of the financial system, especially in light of disturbing trends in nonperforming loans, revision of the banking law and the BCD statutes as well as reinforcing the BCD supervision capacity should be a priority.

The authorities' commitment to a prudent external debt management, resorting only to concessional financing, is noteworthy. We welcome their intention to regularize relations with external creditors in the coming months. We call on the authorities to further strengthen the institutional framework for debt management, with a view to avoiding any new accumulation of external arrears and improving data availability and reporting.

To restore competitiveness and enhance growth prospects, Djibouti needs to accelerate the pace of structural reforms. However, the pace of implementation is hindered by capacity constraints and the unfavorable regional and domestic political environment, as indicated by Mr. Ondo Mañe. The establishment of a new institutional framework to better coordinate and monitor implementation of reforms is welcome. Privatization of electricity, water, and telecommunications companies, in cooperation with the World Bank, should be stepped up to improve efficiency and service delivery. Following tripartite consultations, the planned revision of the labor code promises to consolidate and deepen the recent labor market liberalization measures. We welcome efforts aimed at revising the investment code by streamlining and rationalizing incentives and providing a legal framework for private investment which is transparent, simple, and investor-friendly. Work should also continue on the revision of the commercial code by drafting new legislation.

The ongoing progress in the preparation of the PRSP based on a broad participatory process and a strong country ownership is encouraging, and we note the authorities' intention to finalize the full PRSP by end-March 2003. However, this timetable remains ambitious, given the magnitude of the remaining tasks, namely, expanding the consultation process, updating the poverty profile, costing and prioritization of programs, preparing a consistent medium-term macroeconomic framework, and developing a credible growth strategy. We, therefore, see merit in seeking further donors' support and adopting a more realistic timetable.

Mr. Alazzaz submitted the following statement:

Djibouti continues to face demanding policy challenges. The economy's already difficult situation from the adverse effects of past natural disasters and regional conflicts has been compounded by uncertainties related to the region's increased geopolitical tensions. Indeed, even with none of these aggravating factors, the policy challenge is daunting for Djibouti as an extremely poor country with a scant resource base to manage the needs of a relatively large and young population. Given that background, I am encouraged by the authorities' demonstrated determination to persevere with the adjustments and reforms agreed under the PRGF-supported program.

That said, more clearly needs to be done. Specifically, sustaining faster growth within a viable macroeconomic environment is critical to reverse the continuing drop in the country's already very low per capita income. To that end, the focus should be on redoubling of efforts to implement the program goals fully. Here, the staff has made a number of useful suggestions for improved policy performance.

I join the staff in commending the progress made on the fiscal front. Indeed, Table 1 of the staff report should have highlighted the evidence in that regard. As shown in a memorandum item of Table 2, the improvement on the domestically financed fiscal balance exceeds the program goal for 2002. This represents a considerable effort in increased revenues and decreased arrears as well as spending reallocation to poverty reducing priorities. It is also encouraging that the authorities intend to intensify the effort to both increase priority spending and lower the deficit. This is to be achieved mainly through a more proactive stance on lowering the wage bill. In that connection, close consideration should also be given to the staff's suggestions for further action to address budgetary reforms and the domestic arrears problems.

On the external debt, I welcome the progress made in regularizing relations with creditors. I am also encouraged by the strengthened efforts toward a more dependable debt management process. Indeed, the importance of progress in that regard is highlighted by the regrettable instance of a Fund disbursement becoming noncompliant because of poor communication among the concerned departments. I support the proposed grant of a waiver in view of the evident lack of intent to misreport, the small size of the misreported amount, and the extent of the authorities' subsequent corrective action.

Regarding the currency board arrangement, I agree with the staff that the importance of maintaining competitiveness requires consideration of all options, including a review of the exchange rate level. This will need to be given further thought in the light of the progress in advancing the pending agenda on fiscal improvements and structural reforms. Also, the increase in nonperforming loans highlights the importance of further progress in the ongoing financial system reforms. In that connection, I welcome the focus on improved bank supervision and the related personnel development with Fund technical assistance.

On other structural changes, the staff is right to commend the authorities for the progress on pension reforms. The need now is to take these initiatives further and proceed boldly in the still pending agenda on other difficult areas, including increased military demobilization and privatization. In that connection, I am encouraged by the authorities' focus on simplifying and improving the existing investment incentives, as outlined in Box 4.

While I am looking forward to the full PRSP, I do not view the delay in getting to the final version as either surprising or a major impediment to proceed with the country's policy priorities. Indeed, as already agreed, the broad priorities have been identified in the I-PRSP. In that context, it should also be pointed out that Mr. Ondo Mañe's reference to the resource constraints highlights the dangers of the poverty reduction effort being upstaged by a devotion to the analysis of the poor.

It is evident from the staff's PRSP preparation Status Report that attempts to develop a sophisticated poverty analysis face an enormous challenge in view of the continued data limitations for even the most basic macroeconomic analysis. The problem has been compounded by the lack of qualified manpower. Indeed, as the staff points out, "The professional staff has frequently found it difficult to free themselves from their day-to-day activities". Against that background, I am surprised by the mention in the staff's PRSP Preparation Status Report of yet another subcommittee to be added to the already eight inter-ministerial subcommittees of the national commission working on the final PRSP. Clearly, the focus here should be instead on easing the demands on the country's limited analytical and administrative capacity. Staff comments will be welcome.

With these remarks, I support the proposed decisions and grant waiver, and wish the authorities success.

Extending his remarks, Mr. Ondo Mañe informed the Board that the authorities had consented to the publication of the staff paper and related documents.

Mr. de los Santos made the following statement:

Economic developments in Djibouti during 2001 and 2002 have been dismal, with the main casualty being the poorer segment of the population.

Growth rates for both years have been much lower than expected, with a notable reduction in social spending and a decreased per capita income. It is regrettable that performance under the PRGF-supported program has been weak, with significant delays in implementation and the non-observance of several performance criteria to end-December 2001. We recognize that the country's limited institutional capacity and several exogenous factors, as explained by Mr. Ondo Mañe in his statement, played a key role in these outcomes. We have no doubt that the Djiboutian authorities have been making courageous efforts to improve the country's economic and social conditions, and in that vein we would like to concentrate our comments on the encouraging developments and promising actions undertaken by the authorities since the last program review.

We welcome the significant improvement in the fiscal position during 2002. This has been the result of an important enhancement in revenue collection and a close monitoring and control of expenses. The implementation of the new income tax and the modernization of tax administration have proven successful. We are confident that the authorities will make their best efforts to further improve tax administration, and will follow staff's recommendation to integrate tax management, control, and collection functions. While the current stock of domestic arrears is still sizeable, we recognize the efforts made by the authorities to meaningfully reduce it in 2002, and are encouraged by the recently adopted plan to restructure and repay such arrears within a defined period. Fiscal consolidation should remain a key short-to-medium-term objective. We are assured by Mr. Ondo Mañe's remarks that the fiscal goals for end-2002 will be met, and that a heartening budget surplus is expected in 2003.

Djibouti is still facing a great challenge in enhancing its external competitiveness. We see as promising the authorities' approach to reach this goal by combining internal adjustments with structural reforms aimed at reducing production costs, creating incentives for attracting foreign investment, and diversifying the exports base. Augmenting exports will be crucial for strengthening the external position and supporting economic growth. We take note of the staff's suggestion that this strategy should be complemented with actions on the exchange rate and, in this regard, we would appreciate staff's elaboration on what actions could be feasibly implemented without jeopardizing the currency board regime credibility. We remain sensitive to the authorities' apprehension about the potential negative impact that exchange rate devaluation could have on the banking system or on the most vulnerable groups in the population.

Although the implementation of the structural reform agenda has been less ambitious and slower than expected, we feel encouraged by the notable advances in the fiscal sector and the pension system restructurings, which are key to attaining medium-term fiscal sustainability. We also commend the authorities for the privatization of the airport management and the adoption of a new draft law on combating money laundering, and call them to strengthen their commitment to implement the pending reforming of the labor, investment, and commerce codes.

On the ongoing process of the PRSP formulation, we welcome the fact that stakeholders' participation has been strengthened and national consultation broadened. However, as stressed in the JSA, to assure a more comprehensive and appropriate poverty reduction strategy document, the participatory process should continue to expand and coordination between official agencies improved. We also note that more work is needed to better orient sectoral strategies toward poverty reduction goals, to better assess the dimension of poverty and its trends, to identify key policies and fully cost their goals, to design follow-up mechanisms and indicators for monitoring progress, and to identify an adequate safety net system. In this regard, we support the staff's call to the authorities to seek donors' advice and support in these endeavors. The enhancement of capacity in compilation and elaboration of macroeconomic and social data needed for an adequate implementation and monitoring of the poverty reduction agenda is also warranted.

Regarding the provision of inaccurate information by the authorities on the clearing of all arrears to multilateral creditors before the conclusion of the second review, which constituted a case of noncomplying disbursement, we would like to commend the authorities for their resolve to amend the misstep and for their action to clear such arrears by September 2002. We welcome the recent adoption of the new debt management system, which, as indicated by Mr. Ondo Mañe, will help to prevent misreporting errors. We support the Managing Director's recommendation for a waiver to be granted for the noncomplying disbursement.

In conclusion, we support the proposed decisions and wish the authorities the best in their endeavors.

Mr. Kropas made the following statement:

Let me first thank staff for an informative set of papers and Mr. Ondo Mañe for a helpful statement. Turning to today's discussion on Djibouti's PRGF and PRSP preparation Status Report, I can support the proposed decisions. I have just a few remarks for emphasis.

First, it is regrettable that we had to start the Board discussion with yet another report on noncomplying disbursement. Such cases undermine confidence among the international community in its efforts to help countries to fight poverty. It is reassuring that the authorities have recognized the problem and have already taken a number of important corrective measures of institutional and organizational nature in order to strengthen the external debt management, as outlined in the staff report and in the authorities' letter.

The authorities deserve credit for the progress made under the PRGF-supported program in modernizing the tax administration, strengthening the expenditure management process, clearing domestic budgetary arrears, and protecting the integrity of the financial system. However, further progress is needed in order to reach an effective decline in poverty. I agree with staff that the authorities should accelerate structural reforms by creating an environment conductive to private investment and job creation and pursuing the privatization of public enterprises. These reforms are also crucial for the sustainability of the currency board arrangement.

Concerning the PRSP, I agree with staff that it forms a sound basis for continued access to Fund concessional assistance, and believe that the four main elements of the authorities' strategy are appropriate. However, substantial weakness in sectoral strategies in key areas and incorporation of poverty dimension in the macroeconomic framework are the main risks for the success of the strategy. It would be rather difficult to monitor the implementation of the program without substantial improvements of the statistical infrastructure which appears to be rather weak. The government's commitment to make every effort to address the weaknesses of the current statistical information system is welcome.

Lastly, I welcome the authorities' decision to consent to publication of the reports.

Mr. Ralyea made the following statement:

Djibouti has requested numerous waivers. Frankly, we had expected better performance during the review period under consideration. Nonetheless, we do see reasons to support the completion of this review.

Most importantly, the authorities have generally pursued sound stabilization policies. The implementation of the cash treasury plan since mid-2001 has kept domestic budgetary balances near zero, if not in surplus, and the currency board has contained inflation. Also, the authorities completed key prior actions related to the clearing of domestic and multilateral arrears and the hiring an external auditor of the central bank. Those actions, combined with the proposed budget for 2003, gives us some confidence that the authorities will continue the stabilization effort.

The deviations from the performance criteria, in most cases, were either minor or temporary as well. In certain instances, the authorities have taken corrective actions too. In that regard, we welcome the normalization of relations with external creditors, including the Paris Club. We expect that

Djibouti will now be able to better monitor its obligations and keep current on its external debt payments. However, we also would be interested in hearing why the arrears on the non-complying disbursement noted in Footnote 1 of the staff report do not give rise to another case of misreporting.

Further, the authorities' consent to publication is welcome and a positive factor in assessing the authorities' commitment to pursuing appropriate policies.

Thus, we can agree to the requested waivers. Looking ahead, we fully expect a period of solid policy performance, including implementation of several unfinished structural reforms from this arrangement, to precede Board consideration of any successor PRGF arrangement.

Turning to specific reform issues, allow me to comment briefly on three critical areas.

First, the authorities have made good progress on various budgetary reforms such as the pension system, but more needs to be done. The authorities should incorporate tax exemptions granted under special regimes into the general tax code while limiting their scope of application in terms of goods and time. The authorities must also seek to keep expenditures, including the wage bill, and spending commitments in check. In that regard, we encourage them to devise a system that minimizes the likelihood of new domestic arrears as commitment authority is devolved to line ministries.

Second, the authorities could do more to improve the transparency and accountability of government. We encourage the authorities to publish the list of all creditors whose claims were validated during the audit of domestic arrears. In addition, the authorities should adhere to their own procedures for ensuring that privatizations are conducted in a transparent and fair manner. Just as important, we strongly urge the authorities to institutionalize the external audit mechanism of the central bank and to improve the quality and disclosure of statistical data. With respect to the latter point, we urge the authorities to consent to publication of the staff papers.

Third, we support the authorities' desire to lower factor costs and attract foreign investors through internal adjustment and structural reforms. The steady appreciation of the real effective exchange rate suggests that the urgency for undertaking such measures is growing. To a large extent, the success of Djibouti's port operations—a significant source of economic activity—depends upon Djibouti's external competitiveness.

If the authorities determine that exchange rate realignment will be necessary to spur growth, we believe the CFA Franc countries' experience with devaluation may provide useful lessons. In any case, fiscal consolidation, social safety net issues, and improved banking supervision should all be addressed prior to any realignment. A realistic assessment would also have to be made of the effect of a devaluation on residents with debts denominated in foreign currency and the prospects for real wage adjustment.

With respect to development of a poverty reduction strategy, we agree with the government's plan to focus its poverty reduction strategy on fostering economic growth. We also share the staff's concern that the envisaged timetable seems ambitious in view of what remains to be done, including the further analysis needed to develop a credible economic growth strategy.

Finally, Djibouti has been very supportive of international efforts to block the funding of terrorists; we encourage Djibouti to continue its efforts to block the assets of all terrorists.

Mr. Ayala made the following statement:

We thank the staff for a well-written report and Mr. Ondo Mañe for his helpful statement. Since we broadly concur with the staff's appraisals, we will confine our comments to a few areas for emphasis.

Even when the economic performance in Djibouti has not been as good as it was expected to be, we can observe important progress in some areas in an environment of very low inflation. We note the authorities' significant efforts to improve fiscal discipline, mainly as a result of better tax administration and strict implementation of the cash treasury plan. There is also a strong commitment to continue with structural reforms, such as taking corrective measures in pension funds, continuing military demobilization, and initiating the privatization of the remaining public enterprises in order to encourage private sector participation and improve service delivery. In this regard, we welcome the authorities' recognition that structural reforms and financial stability are crucial to improving external competitiveness in order to foster economic growth and reduce poverty. In that sense, we encourage the authorities to follow the staff's suggestion in order to speed up the pace of structural reforms.

The strengthening of banking supervision is crucial to achieving a sound, credible and effective financial system. We encourage the authorities to implement their commitment to inspect all banks and main money changers once a year, starting in 2003. It is important to know the situation of each component of the financial system, in order to take corrective measures at the proper time, and to maintain the stability and integrity of the system.

The improvements the authorities have made on external debt monitoring and reporting are commendable. We concur with staff that such progress will help to avoid new accumulation of external arrears, and would therefore improve relations with external donors and facilitate incoming flows of external resources in support of Djibouti's reform efforts.

Regarding the noncomplying disbursement, we support the recommendation to grant the requested waiver, due to the corrective measures taken by the authorities, the minor amount of the arrears, and the fact that the situation has been normalized.

We consider that progress in the development of the full PRSP is commendable. However, we concur with staff that the authorities should improve the focus of sectoral strategies towards poverty reduction goals and provide implementation indicators, in order to take the necessary corrective measures to reach the final target. We also agree that the authorities should consider a more feasible deadline to finalize the full PRSP given the pending tasks.

While some progress has been achieved under the third year of the PRGF arrangement, there are still significant challenges and efforts to be accomplished by the authorities which require the Fund's support. On these grounds, we agree with staff's recommendations and support the proposed decision and waivers, wishing the authorities success in their future endeavors.

Ms. Duriyaparpan made the following statement:

We commend the staff for a comprehensive review of Djibouti's economic developments and improvements under the PRGF-supported program. Although there have been delays in the implementation of some measures, owing to limited institutional capacity and a lack of qualified personnel, the authorities have achieved progress in many areas. We fully support staff recommendations for completion of the third review of the PRGF-supported program for Djibouti. Improvement on the fiscal front, through higher revenue collection and reduced spending, is a welcome step. A revamping of the income tax system, as well as the ongoing process of modernizing the administration of taxes and customs, will further enhance revenue potential and improve the fiscal position.

On efforts to improve external competitiveness, the authorities have explored the possibility of establishing a free trade zone outside the city of Djibouti. The authorities have also made progress in improving their database on external debt—with assistance from the World Bank. Despite all the progress achieved thus far, we would like to highlight several areas that need to be further addressed.

Under the current circumstances, in an effort to achieve sustainable economic growth and strengthen external competitiveness, the implementation of fiscal management and structural reform alone may not lead to the desired result. Although it is believed that an appropriate exchange rate level would provide the authorities more flexibility for macroeconomic management, the adjustment of the nominal exchange rate, or exchange rate depreciation, as recommended by the staff, would only be a temporary solution. We also recognize the vulnerabilities that might occur as a result of the adjustment in the exchange rate. Therefore, technical assistance from the Fund, to explore the available options for exchange rate adjustment, would be helpful.

With regard to legal reform, we would encourage the authorities to expedite efforts to establish the institutional framework for labor and investment, as well as commerce codes. So far there has not been significant progress. By improving the investment climate, these reforms constitute integral measures for attracting potential investors. As private sector investment is one of the key factors in achieving sustainable economic growth, there is also an urgent need for a one-stop agency to process potential investments.

On fiscal adjustment, as pointed out by Mr. Shaalan, the potential for further gains on the revenue front is limited. The authorities should instead concentrate on exercising restraint with expenditures, including the reduction of wages and salaries. In regard to domestic budgetary arrears, we commend the authorities for putting in place the necessary framework to clear the debt stock. However, to be more effective, a more forceful plan could be initiated to shorten the time needed to dispose of the domestic debt stock.

Regarding noncompliance in honoring external commitments, we praise the authorities for taking prompt corrective action. However, it is in the best interests of the Djibouti authorities to strengthen external debt management in order to prevent the recurrence of a missed debt payment. Effective systems for monitoring and evaluating external payments are critical to enable the authorities to improve external debt management.

In conclusion, Djibouti has made every possible effort to meet program targets under the PRGF arrangement. Given the institutional limitations, Djibouti should be given a chance to prove that it is worth continuing the implementation of the reform program, under the guidance of the Fund.

We wish success to the Djibouti authorities.

Mr. Boitreaud made the following statement:

The performance under the program for 2001 and early 2002 was below expectations. But, as underscored by Mr. Ondo Mañe in his helpful statement, this is in part due to structural and external factors, including the small scale of the economy and its limited resources, the narrow production base, the difficult climatic conditions, the protracted tensions in the region, and the consequences of political tensions in terms of inflows of refugees. Given these factors, and the limited administrative capacity, the authorities' goodwill and commitment to address major arrears (a weakness of the country) should be commended. In particular, progress has been recorded on the fiscal side, with the successful implementation of the new income tax and the modernization of the tax administration. The completion of the audit of the domestic budget arrears, and the adoption of a ten-year plan to clear the arrears, are also welcome steps. In this context, we agree with the staff that the approval of the review, and the granting of waivers, are warranted.

There is no room for complacency, however, as economic growth remains too low to contribute to a decline in poverty. GDP per capita has been constantly declining for several years, and the reform agenda is far from finished, as underlined in the staff's well-written report. In particular, the much-delayed legal codes should be adopted as soon as possible.

Going forward, continuous adjustment efforts are critically needed on the structural front, especially to reduce the wage bill, which should be accomplished through military demobilization. Given the scope of the remaining challenges, like other Directors, we look forward to the Fund's continued engagement in Djibouti, and hope that a successful program can be negotiated. My authorities stand ready to pursue cooperation with the government of Djibouti, as underscored recently by the disbursement in November of bilateral budgetary assistance of six million euros.

Regarding external debt issues, we welcome the recent progress, and, like Mr. Ralyea, we hope for the rapid conclusion of other bilateral residual agreements with Paris Club creditors. Let me also take this opportunity to insist on the need for coordination among foreign donors, and for close cooperation between the authorities and those donors, whether they are bilateral or multilateral donors, such as the European Commission.

On the issue of the adjustment of the exchange rate, we are sympathetic to the concerns expressed by the authorities on the risks of devaluation. It is important that the possible adverse impact of such an adjustment be carefully assessed, in balance with potential benefits for Djibouti's economy, which will inevitably be constrained by the narrow production base and high dependence on imports.

Finally, on the noncomplying purchase and in light of its minor and temporary nature, we support the recommendation to grant a waiver. We welcome the authorities' decision to adopt corrective measures to strengthen compilation and management of the external debt database, and to simplify budgetary procedures. We urge them to sustain these efforts to make sure that such an incident will not be repeated in the future. We welcome the authorities' decision to publish the documents and wish them success in their endeavors.

Ms. Muganda made the following statement:

We recognize the numerous constraints and difficult circumstances facing the Djiboutian authorities, ranging from lack of a critical mass of trained personnel to limited institutional capacity, not to mention the geopolitical context. Nonetheless, the authorities have managed to maintain a stable financial environment while progressively settling domestic arrears. The balance of payments has improved markedly in the recent past; moving to an overall surplus, while real per capita GDP has somewhat improved this year. We commend the authorities for the progress made thus far.

We note the various reforms implemented in the fiscal area including modernizing and streamlining the tax and customs administrations, an important step in enhancing domestic resource mobilization. We are encouraged by the authorities' intention to intensify their effort toward lowering the budget deficit while safeguarding priority expenditures. In this respect, we urge the authorities to take into account suggestions made by staff regarding taking further action to address budgetary reforms and domestic arrears.

Like others, we welcome the authorities' efforts towards normalizing relations with creditors and their commitment to prudent debt management. In this regard, we are pleased to note in Mr. Ondo Mañe's statement that the authorities have taken measures to strengthen compilation and management of the external debt database and to simplify budgetary procedures in order to enhance monitoring and execution. Strengthening of the institutional and administrative capacity of the debt management system should facilitate improvement in external debt monitoring and reporting so as to prevent a recurrence of misreporting errors incidents, as well as avoiding accumulation of external arrears. We concur with Mr. Ondo Mañe's view regarding the need for technical assistance in this area. Nonetheless, we commend the authorities for taking the appropriate measures and the recent efforts to clear all arrears on external debt and to sign rescheduling agreements with Paris Club creditors.

Like Mr. Shaalan and Mr. Bakhache, we look forward to the Fund's continued engagement in Djibouti. We also hope that a mutually agreeable program can be considered in order to help Djibouti to build on progress made thus far and to facilitate an enabling environment for growth.

With these remarks, we join others in supporting the authorities' request for waivers and support the proposed decision.

The staff representative from the Middle Eastern Department (Mr. Toujas-Bernate) made the following statement in response to questions and comments from Executive Directors:

> Let me first address one concern that was raised by Mr. Alazzaz, regarding the institutional framework and associated establishment of an additional committee to work on the final PRSP, and the concern about the additional strain this might place on the limited administrative capacity. This institutional framework, which consists of an interministerial committee, chaired by the Prime Minister, and several technical committees, is meant to better coordinate and guide the work of the whole administration. It was noted that different agencies had difficulties in coordinating their work, and so this institutional framework will serve as an umbrella for all the committees and working groups that are already in place. Therefore, it is not expected to present an additional burden to the existing administrative capacity of Djibouti, which is indeed limited.
>
> On the issue of the exchange rate, raised by Mr. de los Santos, this was extensively discussed during the 2001 Board meeting, and we noted the divided views among Directors. This issue should be looked at against the background of Djibouti's external competitiveness, which has deteriorated significantly in the last two decades, and the slow economic growth performance. The strategy followed by the authorities so far—implementing structural reforms and maintaining a stable macroeconomic framework—has not led to significant results, particularly in terms of economic growth. We encourage the authorities to explore seriously all envisaged policy options, including possible action on the exchange rate. This is a delicate issue, which will need to be considered carefully. One can envisage the continued existence of the currency board, with a different parity, under certain conditions. The staff will be ready to assist the authorities in analyzing this possibility as soon as the authorities indicate this wish.
>
> We were asked by Mr. Ralyea why the arrears due by a public enterprise to one multilateral creditor did not give rise to another case of misreporting. This is somewhat technical, and I will try to be as clear and concise as possible. I would first like to remind the Board that it is granting waivers on performance criteria, on the basis that information provided by the authorities is accurate. In this case, before the second review, the authorities sent a letter to the staff indicating that all arrears to multilateral institutions were cleared. This was understood by both the staff and the authorities to cover only direct government debt arrears, because at that time the staff was not aware of the details of arrears due on government-guaranteed debt by public enterprises. Therefore, there is a distinction to make between arrears on direct government debt and on the arrears due by a public enterprise to the European Investment Bank, which the staff knew about only after the second review. This simply was a case where the authorities did not provide

information, as opposed to providing inaccurate information. As they did not provide misinformation, this does not give rise to a case of misreporting. Perhaps Mr. Ahmed could complement this explanation, or we can have staff representatives from the Legal Department explain this further.

Finally, several Directors encouraged continued engagement of the authorities by the Fund. The staff will be ready to continue to advise the authorities and to build upon the progress achieved so far. We intend to conduct a stock-taking exercise, putting the lessons of the implementation of the current program in the context of the next Article IV consultation, which we expect to take place in the first quarter of 2003. Then, should the authorities indicate their interest in a successor program, we would be ready for discussions on the possibility, and the conditions, for such a successor program.

Mr. Ralyea, indicating that he might pursue the issue further on a bilateral basis if necessary, asked for additional clarification on misreporting guidelines, and considered that a country that provided no statistical information could theoretically avoid incurring incidents of misreporting. Although the Board usually did not attempt to establish intent, and in this case the withholding of information likely had been inadvertent, in general the withholding of information relevant to the approval or success of a program should have been considered important and material in the case of misreporting incidents.

The Deputy Director of the Policy Development and Review Department (Mr. Ahmed) responded that the authorities had not failed to provide available information, rather, both the staff and the authorities had understood that, at the time, details about the arrears of public enterprises had not been available. The information that the authorities had provided at the time was on the basis of the information they had gathered, and the staff had understood it to cover the direct arrears of the government, not the arrears of public enterprises. In this case, there had been a clear understanding, between the authorities and the staff that the information available at the time covered direct public arrears, and the fact that other arrears elsewhere had subsequently come to light had been unfortunate, but it had not been part of the representation provided or understood at the time.

The Acting Chair (Mr. Sugisaki) asked Mr. Ralyea if the guidelines on misreporting were now clear to him.

Mr. Ralyea responded that it had been clarified somewhat, but implied that he might require further explanation at a later time.

The Acting Chair (Mr. Sugisaki) requested that a staff representative pursue the issue further on a bilateral basis with Mr. Ralyea.

Mr. Ondo Mañe made the following concluding statement:

Let me thank Directors for their support of the proposed decisions, and for their comments and policy recommendations, which I will transmit to my Djibouti authorities. I would also like to thank the staff for addressing the issues raised by Directors. I will be brief in my remarks.

Directors have noted the weak implementation capacity of Djibouti. I will not disagree, but nevertheless, I would point out that a number of measures have been taken. We have to recognize that, even with this limited capacity, the authorities have undertaken an ambitious program of reform, which they know is important for the future of Djibouti. In assessing Djibouti's performance, these reforms should be kept in mind. The country will continue with the reform process, but we will need to make sure that the authorities receive adequate technical assistance, so that they can take the measures that are called for.

On a successor program, I would like to reassure Directors that my authorities fully agree with the staff that any program will have to focus on ensuring strong economic growth. In that context, several Directors have commented on the exchange rate, and recommended that the exchange rate is one of the elements that should be reconsidered. We need to look at all the factors, but a careful and comprehensive analysis will be made regarding any proposed change in the exchange rate policy. My authorities have pointed out that such an approach has the potential to aggravate, in a significant way, the exchange rate market. In any event, we will need to move prudently on this issue.

The domestic debt is another one of the concerns of the Djibouti economy. With the support of external assistance, my authorities have put in place a plan that would allow them to pay their arrears over a period of ten years. However, my authorities remain hopeful that additional external assistance will help them to solve this problem in a shorter period of time.

Let me conclude, and thank the Directors for their support, and the staff for an excellent job.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They were encouraged by the progress made in improving fiscal discipline, enhancing transparency in public finances, and strengthening the legal framework for financial operations. However, they expressed concern about the slow pace of structural reforms and regretted that several quantitative and structural performance criteria under the program were not met, while recognizing the authorities' limited institutional capacity and their efforts to take corrective actions. Going forward, Directors looked forward to a strengthening of policy implementation to ensure access to assistance under a PRGF-supported program in the future.

Directors observed that despite progress in financial stabilization, economic growth remains insufficient to reduce unemployment and alleviate rising poverty, and that the economy remains highly dependent on the port and the related activities as well as on foreign military presence. They saw an urgent need for a comprehensive strategy to promote private investment and job creation.

Directors welcomed the authorities' efforts to improve the fiscal situation by strengthening budgetary revenue collection and containing expenditure through strict adherence to a cash management plan, while allowing a modest increase in social expenditures. They regretted, however, that the wage bill in 2002 was not reduced as planned because of slower military demobilization. Directors therefore encouraged the authorities to continue their policy of fiscal consolidation in 2003, and welcomed the intentions of the authorities to keep the wage bill under control to allocate more resources to priority social sectors. They encouraged the authorities to stand ready to implement contingency measures in case of revenue shortfalls.

Directors commended the authorities for the successful introduction of a new income tax and for progress in modernizing tax administration. They stressed the need to build on this progress by better integrating the functions of tax management, control, and collection in preparation for the introduction of the value-added tax in the near future. Directors also commended the authorities for strengthening public expenditure management, while the new organization of the finance ministry will help rationalize budget preparation, execution, and control. They encouraged the authorities to complete this comprehensive reform by adopting soon new spending procedures that would involve line ministries.

Directors welcomed the completion of the audit of domestic budgetary arrears and the adoption of an overall plan to clear them over the next decade as a major step in restoring the government's financial credibility. They urged the authorities to implement the plan with determination and full transparency, and to seek external support in the broader context of Djibouti's poverty reduction strategy.

Directors considered that Djibouti's currency board arrangement has contributed to keeping inflation low but has undermined external competitiveness. They emphasized that prudent financial and broad-based structural policies will be needed to improve competitiveness now so as to achieve higher economic growth and reduce widespread poverty in the medium term. They advised the authorities to carefully consider all options in restoring external competitiveness in the medium term.

Directors welcomed the authorities' actions to clear or reschedule all arrears on external debt and to sign rescheduling agreements with Paris Club creditors, and urged them to seek comparable treatment from non-Paris Club creditors. In this regard, they regretted that a case of misreporting was established leading to a noncomplying disbursement following the completion of the second review under the PRGF arrangement. However, they welcomed the clearing of all external payments arrears. Directors commended the authorities for the recent initiatives to improve external debt monitoring and reporting. They emphasized the need to continue these efforts in order to avoid any new accumulation of external arrears and help keep good relations with external donors, thus ensuring more steady flows of external resources in support of Djibouti's reform and poverty reduction efforts.

Directors considered that the adoption in 2002 of an anti-money laundering law and the beginning of an external audit of central bank accounts were important steps in protecting the integrity of Djibouti's financial system. They encouraged the authorities to complement these achievements by adopting the revised draft banking law and the central bank statutes. They also urged a strengthening of the central bank's banking supervision capacity and more frequent inspections of financial institutions.

Directors urged the authorities to accelerate structural reforms and welcomed the establishment of a new institutional framework to coordinate implementation of economic policy and reform. While welcoming the recent privatization of the management of the airport, Directors were concerned about the delay in the preparation of action plans for privatizing other public enterprises, and urged the authorities to move forcefully in this area, in line with their privatization strategy and in consultation with the World Bank. Efforts in other structural reform areas, including on the labor code, the investment code, and the commerce code, will also need to be intensified.

Directors considered that progress on the development of a full Poverty Reduction Strategy Paper (PRSP), as evidenced by the PRSP Preparation Status Report, is satisfactory and provides a sound basis for continued access to Fund concessional assistance. They endorsed the joint staff assessment of the PRSP Preparation Status Report. Given the magnitude of the remaining tasks, the authorities were encouraged to seek further donors' support and to adopt a realistic timetable.

The Executive Board took the following decisions:

Report on Noncomplying Disbursement and Recommendation for Corrective Action

The Fund notes the report of the Managing Director set forth in EBS/02/208 (12/9/02) on the noncomplying disbursement made to Djibouti following the completion of the second review under the PRGF arrangement for Djibouti on November 30, 2001, and decides to waive Djibouti's nonobservance of the condition for that disbursement on the condition that the revised information provided by Djibouti on the observance of that condition is accurate. (EBS/02/208, 12/9/02)

Decision No. 12916-(02/126), adopted
December 20, 2002

Poverty Reduction and Growth Facility—Review, and Waiver of Performance Criteria

1. Djibouti has consulted with the Fund in accordance with paragraph 2(dd) of the three-year arrangement for Djibouti under the Poverty Reduction and Growth Facility (PRGF).

2. The letter dated December 4, 2002 from the Minister of Economy, Finance, and Planning, in charge of Privatization and the Governor of the Central Bank of Djibouti, together with its attached Memorandum of Economic and Financial Policies (the "2002 MEFP"), shall be attached to the PRGF arrangement for Djibouti, and the letters dated October 2, 1999, July 11, 2000 and November 14, 2001 from the Minister of Economy, Finance, and Planning, in charge of Privatization and the Governor of the Central Bank of Djibouti, together with their respective attachments, shall be read as supplemented by the letter dated December 4, 2002 and the 2002 MEFP.

3. The Fund has reviewed Djibouti's PRSP Preparation Status Report (EBD/02/162, 12/12/02), and determines that progress on the development of the full PRSP, as evidenced by the PRSP Preparation Status Report, is satisfactory and provides a sound basis for continued access to Fund concessional financial assistance.

4. The Fund decides that the third review contemplated in paragraph 2(dd) of the PRGF arrangement for Djibouti is completed and that Djibouti may request the fourth disbursement referred to in paragraph 1(cc)(i) of the arrangement, notwithstanding the nonobservance of:

(a) the end-December 2001 performance criterion on the ceiling on the stock of outstanding domestic arrears on the wage bill and to private suppliers, public enterprises, and pension funds set out in paragraph 2(a)(ii) of the arrangement;

(b) the end-December 2001 performance criterion on the ceiling on the stock of outstanding external arrears of the government and public enterprises set out in paragraph 2(a)(iii) of the arrangement;

(c) the end-December 2001 performance criterion on the ceiling on commercial bank net credit to the government set out in paragraph 2(a)(v) of the arrangement;

(d) the end-December 2001 performance criterion on the floor on net international reserves of the Central Bank set out in paragraph 2(a)(viii) of the arrangement;

(e) the end-December 2001 performance criterion on the floor on domestic budgetary receipts set out in paragraph 2(a)(ix) of the arrangement;

(f) the end-December 2001 structural performance criterion on the retirement of at least 850 civil servants and government employees eligible for retirement set out in paragraph 2(bb) of the arrangement;

(g) the performance criterion on the non-accumulation of new external arrears set out in paragraph 2(c)(v) of the arrangement; and

(h) the performance criterion on the reporting of data on foreign trade, revenue, expenditure and budgetary arrears set out in paragraph 2(c)(vii) of the arrangement, on the condition that the information provided by Djibouti on the observance of these performance criteria and the implementation of the prior actions set out in Section I of Table 1 of the 2002 MEFP is accurate. (EBS/02/212, 12/11/02)

Decision No. 12917-(02/126), adopted
December 20, 2002

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/02/125 (12/19/02) and EBM/02/126 (12/20/02).

4. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to Executive Director as set forth in EBAM/02/155 (12/18/02) is approved.

APPROVAL: February 20, 2003

SHAILENDRA J. ANJARIA
Secretary