May 25, 2001
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 99/55

11:00 a.m., May 24, 1999

Contents

Executive Board Attendance

A.D. Ouattara, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
	S.M. Al-Turki
A. Barro Chambrier	
	P. Charleton
	T. Turner-Huggins, Temporary
R.F. Cippà	F. Zurbrügg, Temporary
	W.-D. Donecker
N. Eyzaguirre	A.G. Zoccali
	O.A. Hendrick, Temporary
	J.N. Santos, Temporary
	G. Schlitzer, Temporary
J. Guzmán-Calafell	J.L. Pascual, Temporary
	E. González-Sánchez, Temporary
	O.-P. Lehmussaari
	C. Harinowo
	R. Djaafara, Temporary
	J. Prader
	M. Nemli, Temporary
	B. Repanšek, Temporary
K. Lissakers	B.S. Newman
J.-C. Milleron	R. Fernandez
	B. Couillault, Temporary
A. Mirakhor	
	J.M. Jones, Temporary
	A. Lushin
	L. Palei, Temporary
S. Pickford	S. Collins
	J.C. Estrella, Temporary
A.S. Shaalan	A.F. Al-Faris
	A.G. Karunasena
G.F. Taylor	K. Ongley, Temporary
Wei Benhua	Luo Y., Temporary
	Y.G. Yakusha
	E.J.P. Houtman, Temporary
	A. Kapteijn, Temporary
	E. Azoulay, Temporary
	H. Ogushi, Temporary
	D. Fujii, Temporary
	K. Gobe, Temporary

R.H. Munzberg, Secretary
A. Linde, A. Mountford, and J. Prust, Acting Secretaries
P. Cirillo, Z. Ahmed, and N. Hairfield, Assistants

Also Present

IBRD: B.T. Ngo, Africa Regional Office; Z. Allaoua, A.J. McKechnie, South Asia Regional Office. African Department: E. Hernandez-Cata, Deputy Director; E. Sacerdoti, C.A. Francois, N. Kirmani, P.J. Lazar, N. Ntungwanayo, J.-P. Olters, E. Verreydt. Asia and Pacific Department: W. Tseng, Deputy Director; I. Otani. European I Department: A. Leipold, A. Zanello. European II Department: M. Shadman-Valavi. External Relations Department: R.W. Russell. Fiscal Affairs Department: P.S. Heller, Deputy Director; A. Kuijs. IMF Institute: N.U. Haque. Legal Department: W.E. Holder, Deputy General Counsel; H. Elizalde, N. Kyriakos-Saad. Middle Eastern Department: P. Chabrier, Director; D. Burton, Deputy Director; S. Eken, P. Gajdeczka, M. Lazare, K. Nashashibi. Policy Development and Review Department: J. Boorman, Director; I. Kapur, Y. Metzgen, C. Muniz B., P. Price, J. Seade, S. Tareq, R. Weber. Research Department: P. Cashin. Secretary's Department: P. Gotur, B.A. Sarr. Treasurer's Department: D. Williams, Treasurer; J.E. Blalock, B.V. Christensen, M.M. Cuc, L.U. Ecevit, K.M. Kenney, M. Kuhn, M. Lari. Western Hemisphere Department: C. Cha, K. Honjo. Office of the Managing Director: D. Citrin, S. Tiwari. Office of Budget and Planning: E.-A. Conrad, Director; N. Sachdev. Advisors to Executive Directors: M.A. Ahmed, P.A. Akatu, M.H. Elhage, S.S. Farid, A.R. Ismael, N. Jadhav, J. Jonáš, H. Mori, Y. Patel, M.R. Shojaeddini, I.M. Woolford. Assistants to Executive Directors: A.S. Alosaimi, N.R.F. Blancher, J.G. Borpujari, K.S. Brownlee, R. Burgess, P. Cabezas, J. Chelsky, V. Dhanpaul, M.J. Fernández, M.S. Hililan, S. Hinata, C. Josz, K. Kask, S.K. Keshava, S.N. Kioa, E. Kornitch, K. Kpetigo, D.H. Kranen, T.-M. Kudiwu, S. Le Gal, Lu A., S.D. Melese-d'Hospital, W. Merz, J.A.K. Munthali, M. Pérez, Qi J., L. Redifer, V. Rigász, S. Rouai, D. Saha, M.M. Salvador, C.-P. Schollmeier, U.F. Seyidzade, Sugeng, D. Taylor, M. Vismantas, Vongthieres O., S. Vtyurina, M. Walsh, Wang X., R.P. Watal, P. Winje, I. Zakharchenkov.

1. CAPE VERDE—1999 ARTICLE IV CONSULTATION; AND STAND-BY ARRANGEMENT—REVIEW, EXTENSION, AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered the staff report for the 1999 Article IV consultation with Cape Verde, the second review under the Stand-By Arrangement for Cape Verde, and its request for extension of the arrangement and waiver of performance criteria (EBS/99/71, 5/6/99; Cor. 1, 5/17/99; Cor. 2, 5/19/99; and Cor. 3, 5/21/99). They also had before them a background paper on recent economic developments in Cape Verde (SM/99/107, 5/10/99; and Cor. 1, 5/17/99).

Mr. Barro Chambrier made the following statement:

> Since 1992, Cape Verde has embarked on a comprehensive program of structural adjustment aimed at providing the basis for sustainable growth over the medium term. While good progress was made in the liberalization of the economy and in the privatization process, financial policies initially remained weak and resulted in the accumulation of domestic debt and a loss in reserves. In 1996, the authorities decided to tighten policies and to seek donor support for a domestic debt-reduction operation. These policies were further strengthened in 1998, when the authorities put in place an economic and financial program which received Fund-support under a precautionary Stand-by arrangement. Progress under the program has been satisfactory. The fiscal deficit has been sharply reduced and bank financing eliminated. Furthermore, despite the adverse effects of the drought on the economy, real output grew by more than 5 percent in 1998 reflecting buoyant activity in the tourism and construction sectors. Inflation was more than halved to 4.3 percent. The external current account (excluding transfers) as a ratio to GDP improved, as tourism and workers' remittances increased.
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> Budgetary performance, in 1998, was better than anticipated. Reflecting the government's continued efforts to improve tax administration, revenue exceeded projection. The authorities also continued their close monitoring and control of expenditure. The refinancing of donor-financed investment projects with domestic resources, a major cause of the accumulation of domestic debt, was discontinued, and there was no recourse to bank financing. As a result the overall budget deficit (on a commitment basis) was curtailed; it was reduced by 6 percentage points of GDP from 1997 to 4.3 percent of GDP, in 1998. However, the domestic debt conversion had to be postponed to 1999, as resources in the Trust Fund amounted only to US$29 million, significantly lower than the US $85 million expected at the beginning of the year.
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> In the monetary area, policies were tightened and geared towards containing inflation and supporting the peg of the escudo. Reflecting the

buoyancy of the real sector, and the increase in confidence in the economy, credit to the economy showed a healthy increase in 1998. However, as noted above, there was a slowdown in the pace of project execution so that the government's project-related deposits declined, which overall resulted in a relatively modest increase in net domestic assets of the Bank of Cape Verde. This increase was reversed in early 1999. Moreover, due to delays in external financing, the elimination of the foreign payments queue was achieved only in mid-April of this year. The authorities are requesting waivers for the non-observance of these performance criteria.

Since 1993, when the authorities embarked on a strategy of developing a modern banking system in Cape Verde, efforts have focused on strengthening the banks' competitiveness and financial soundness. In 1998, with the entry into operation of a second foreign bank (increasing the number of competing banks to four), and the reinforcement of the Bank of Cape Verde's supervisory activities, the banking system received an additional impetus. Prudential requirements were tightened in 1998, and the banks were asked to reduce their nonperforming loans. The commercial banks are also in the process of upgrading their communication networks which should allow for real-time interbank transactions and the establishment of an electronic clearing system between the banks and the central bank.

In the external sector, the reduction in the export of goods and nonfactor services was caused by several exogenous factors, all of which being of a temporary nature, but, as noted above as a percentage of GDP, the current account improved. The government has also continued to liberalize its foreign exchange regime, with the full liberalization of current transactions, except for travel for which allowances have been increased. Moreover, it has eliminated all remaining quantitative import restrictions and replaced them with revised customs duties, effective January 1, 1999. The authorities have also indicated their intention to accept the obligations of Article VIII, sections 2,3 and 4. Also, effective January 1, 1999, the Cape Verde escudo has been pegged to the euro.

In the area of structural reforms, all structural benchmarks through end-December 1998 were met. The very comprehensive privatization program, which is being implemented in close cooperation with the World Bank, has encountered some delays due to the need to observe rigorous procedures, but implementation has been greatly accelerated in 1999. The structural performance criterion on the government's adoption of legislation for privatizing the shipyard company, Cabmar/Cabnave could not be met in 1998 due to the complexity of the operation. The authorities are requesting a waiver for the nonobservance of this performance criterion.

Overall, my Cape Verde authorities are broadly satisfied with the progress achieved under the Stand-by arrangement. However, they understand that much more needs to be done to put the economy on the path of financial viability. They share the staff's view that it is essential to consolidate the results achieved. A successful economic and financial performance in 1999 would go a long way towards strengthening investors' confidence, especially at a time when new initiatives are being envisaged by private investors in the areas of tourism and manufacturing. These initiatives would contribute significantly to the creation of new employment opportunities while strengthening the external position. In this context, the authorities remain fully committed to the pursuit of prudent macroeconomic policies, aimed at containing inflation and supporting the exchange rate peg, and to the implementation of appropriate structural reform measures to further improve competition and create a conducive environment for the development of a strong private sector. In support of their efforts, they are requesting an extension of the Stand-by arrangement with the Fund to end-1999, and an increase of the size of the arrangement to 26 percent of the new quota. As they had done in the past, the authorities do not intend to make any purchase under the arrangement, but would like to have this additional precautionary cushion in case of need.

The authorities view the prospects for 1999 with optimism. On the basis of present policies and in the absence of any adverse exogenous shocks, real GDP is projected to grow by 6 percent, inflation to decline to 3 percent and the external position to continue to improve, with a further strengthening of the reserve position.

Fiscal policies, in 1999, are geared towards improving the current budgetary surplus to 2.9 percent of GDP. The government continues with its efforts to fully abstain from domestic borrowing. In this context, tax revenue is projected to increase in 1999, mainly as a result of higher customs revenue, as all remaining import restrictions have been replaced with revised and simplified customs duties. As many enterprises have come to the end of their tax-exemption period, profit taxes are expected to increase as well. On the expenditure side, the authorities are targeting an increase in outlays for recruitment of teachers and health personnel, as well as larger allocations for priority goods and services. The public investment program is also projected to accelerate, after the slowdown in 1998. In addition, the government has started an emergency labor-intensive program aimed at alleviating poverty in areas most affected by the 1998 drought. The program will be financed by external grants and by a special fund, which will receive the proceeds of the sales of government shares in the telecommunications and the petroleum distribution companies to resident investors. However, if precipitation in the affected areas improves, then the program will be proportionally reduced. The authorities intend to continue their efforts to strengthen budgetary procedures by introducing a centralized monitoring mechanism of budget execution and putting in place a new government accounting system. They are continuing work on simplifying the customs tariff system and are examining the possibility of introducing a VAT within the next two years, with Fund technical assistance.

The authorities expect the domestic-debt reduction operation to start this year. Disbursements from multilateral and bilateral donors are expected to reach US$ 73 million by mid-year, with privatization receipts expected in the second half of this year. As a result interest charges on domestic debt are expected to be reduced sharply in 1999.

The objectives of monetary policy, in 1999, will remain the containment of inflation and the support of the exchange rate peg. Growth in credit to the economy is projected at 12 percent with no increase in net bank credit to the central government. With the elimination of bank-by-bank ceilings, the monetary authorities intend to make greater use of money market operations to control bank liquidity. The central bank will issue short-term securities, which will be tradable among financial institutions.

With the agreement on new procedures with the World Bank, the authorities expect the structural reform program, especially the privatization process to gain momentum. By end-2000, the privatization program of 17 enterprises started in 1998 is expected to be completed. The authorities are also focusing their efforts on the reform of the regulatory and judicial system and on services that support the private sector. A stock market is in the process of being established in Praia and is expected to become operational this year.

The Cape Verde authorities are of the view that the policies and measures they intend to implement in 1999 will help achieve the objectives set in their program, and will also contribute to the achievement of their medium term objectives. They are, therefore, hopeful that they will continue to receive the full support of the international community in these efforts.

Mr. Mori made the following statement:

The economic reform program followed by Cape Verde has produced remarkable results. The average annual GDP growth rate was 5 ½ percent for the period 1992-98. The GDP growth rate was about 5.2 percent in 1998. Average annual inflation was reduced to 4.3 percent in 1998 from 8.5 percent in 1997, despite the drought and devaluation of the Cape Verde escudo. However, difficult challenges remain as, even after this favorable period of strong growth, unemployment is still high, and poverty is widespread, especially in the rural area.

The fiscal outcome in 1998 was satisfactory with higher than expected budgetary and primary surpluses, and there was no recourse to bank financing by the central government. The authorities' efforts in strengthening the tax administration resulted in an increase in the government revenue-to-GDP ratio from 19.5 to 21.3 percent between 1997 and 1998. Total expenditure has been maintained approximately constant, reducing central government spending in terms of percent of GDP.

A priority in the fiscal area will be to seek further improvements in the quality of public expenditure, especially investments in the social area, and perhaps infrastructure, with due regard on cost-effectiveness. As Cape Verde is particularly vulnerable to inclement weather and natural disasters, we see schemes, like the special emergency fund, as instrumental to finance a labor-intensive public works program to mitigate the effects of unfavorable shocks. We agree with the staff's view that this public works program needs to be well targeted and closely monitored to maintain its size within reasonable bounds, taking into account absorptive capacity.

We welcome the progress achieved in the implementation of structural reforms. Structural changes have led to a decrease in government activity in the economy, while private sector investment has increased. The strengthening of bank supervision has allowed the expansion of the banking system in 1998, and the privatization of the entire banking sector is expected to be completed by the end of 1999.

An encouraging change has been observed regarding the Cape Verdean economic structure. Fundamental reforms have led to notable changes both in terms of composition and destination of exports. Structural adjustments and the resulting advancements in quality and productivity have led to improvements in Cape Verde's international competitiveness. Increasing foreign investments, attracted by positive developments and favorable institutional changes, may also have contributed to the process. As a consequence, primary sector exports shrunk to about one-tenth of overall shipments abroad at the end of the decade; and they represented close to nine-tenths at the beginning of the decade. Export growth has also allowed the financing of a larger share of imports.

It is essential to consolidate the progress achieved so far in the macroeconomic as well as structural fronts. The current peg of the Cape Verde escudo to the euro imposes a strict policy discipline, which requires the implementation of consistent monetary and fiscal policies to achieve and maintain internal and external macroeconomic equilibria. In a framework of currency peg, fiscal policy plays a major role. A close monitoring of developments in the monetary area is required to maintain the expansion of credit to the economy at a sustainable rate. In addition to prudent macroeconomic management, structural reform policies need to be continued and reinforced, as they are fundamental to enhance the supply side by increasing productivity and competitiveness to reduce domestic and external constraints.

We support the proposed decision for the completion of the second review under the Stand-by Arrangement and the extension of the arrangement to end-1999.

Mr. Jones made the following statement:

I can support the authorities' request for waivers and for the augmentation to 26 percent of quota. It is clear that in recent years the authorities have been very committed to a broad-based program and progress has been satisfactory. Donor community support also played an important role in helping to advance the process of economic reform. Overall, the government's economic policies have increased private sector confidence, evidenced by the strong inflows of foreign direct investment and large workers remittances.

The outlook for the near term looks good. Growth is expected to remain strong, inflation is on the decline again, and the process of fiscal consolidation remains basically on course. It is also anticipated that the privatization process will gain further momentum. However, there are some problems that need to be addressed and I will mention two.

One is that per capita income is relatively high, but this should not mask the fact that about one third of the population is considered poor, according to the World Bank. Secondly, growth and the increased level of investment have not translated into higher levels of employment. It is reported that unemployment remains at the level of 25 percent.

Interest rate levels seem to be high and the staff reports that the authorities have expressed readiness to tighten fiscal and monetary policy if the inflation rate does not decline as programmed. One wonders whether the authorities are not being too cautious. I wish the authorities well.

Mr. Djaafara made the following statement:

We commend the authorities for progress made in various areas last year. Despite failing rains on several islands, Cape Verdean authorities have succeeded in maintaining the momentum of economic expansion. Output growth in 1998 is only slightly lower than the average growth during transition period. The authorities have also been able to improve macroeconomic balances, reflected by the declines in inflation rate and current account deficit.

We also welcome the revised national account figures that confirm the rapid expansion of Cape Verdean economic activity. The crucial challenge faced by the authorities is to strengthen the macroeconomic foundations to ensure the continuation of these improvements.

It is encouraging to note that the authorities continue to pursue prudent fiscal policy. The authorities' decisions to increase further the current budgetary surplus and eschew any recourse to domestic borrowing will enhance the macroeconomic balances, which are important to the success of structural adjustment being pursued. These fiscal policy's objectives, if achieved successfully, will heighten the government's credibility, which is one of determined factors considered by foreign investors.

We also welcome the authorities' intention to conduct cautious monetary policy. The prudent monetary policy, together with fiscal policy, is needed to contain inflation, and thus to support the exchange rate peg. In this regard, we encourage the authorities to monitor the development of credit to the economy, which expanded rapidly during the first half of 1998. The rapid expansion of credit to the economy, from different perspective, is a sign that private sector is confident to the prospect of the economy. Therefore, the rapid expansion of credit to the economy may emerge again as the economy continues to strengthen. In this regard, we welcome the central bank intention to strengthen its prudential supervision which plays important role in keeping the credit expansion in its healthy zone. The authorities' decision to privatize banking sector would also contribute in enhancing the quality of credit to the economy. In addition, we share the staff's view that monetary policy should be geared to strengthen the level of reserves of the central bank in order to support exchange rate which is now pegged to the euro.

With regard to structural reform, the authorities should be commended for their endeavor to conduct public enterprise reform through privatization. This measure will further strengthen the foundation of the economic development. On the social policy, we share the staff's view that the program of emergency public works directed towards poverty alleviation should be well targeted and its size should be maintained within reasonable bounds.

With these comments, we support the proposed decisions and wish the authorities much success in their endeavors.

Mr. Repansek made the following statement:

In 1991, Cape Verde's single-party political system yielded to democracy, the authorities inherited a structurally challenged economy, heavily dependent on external support. This unpromising start called for a massive revision of the status quo which obviously could not be accomplished overnight.

Now, eight years later, Cape Verde's macroeconomic stability has improved and a number of structural measures have been implemented. Increases in foreign direct investment and worker remittances support the staff's optimism, and are pointing the way to a reduction of Cape Verde's dependence on external support.

I will comment briefly on monetary policy and the unmet performance criteria, concluding with a word on statistical issues.

Monetary policy played a crucial role in achieving macroeconomic stabilization by lowering inflation and improving the economy's competitiveness, where an appropriate exchange rate policy also made an essential contribution. Lower interest rates and a narrower interest rate spread would improve financial intermediation and encourage investment. Just when would the staff recommend that the authorities carry out their intention of lowering the discount rate?

The factor common to the cases of unmet performance criteria is delay. I can go along with the cancellation of unexecuted requests for money transfers abroad which are older than three and a half months. Apparently the unwanted increase of net domestic assets of the Bank of Cape Verde has had no negative effects, but I would appreciate some explanation from the staff of the slowing of project execution that caused it. In light of the authorities' evident commitment to the reforms, I have some sympathy for the explanation that the delays in the privatization process are due not to any lack of zeal on the part of the authorities, but to the rigor of the World Bank's procedures. A well-prepared and well-implemented privatization program ought to improve corporate governance and ensure the profitable development of the privatized enterprises. It should not display the characteristics of fire sale. But because the privatization receipts are needed for domestic debt conversion, I would urge the authorities to pursue privatization vigorously from now on.

Because there is so much remaining to be done, especially in the fiscal and external sectors, I was disappointed to learn that most recent mission on General Financial Statistics found no significant progress had been made in implementing earlier recommendations, and in addition that balance of payments data are seriously deficient. I urge the authorities to address this very soon. I would support any additional Fund technical assistance that the Cape Verde authorities may need.

In conclusion, I support the request for the extending the Stand-by Arrangement, and offer my best wishes to the Cape Verde authorities.

Mr. González-Sanchez made the following statement:

In 1998, Cape Verde was severely affected by droughts on several islands. In spite of this unfortunate event, the country's economy grew by 5 percent in 1998. Indeed, Cape Verde has registered sustained and strong economic growth since 1992. A good management of financial policies contributed to reduce the overall budget deficit (on a commitment basis) to 4.3 percent of GDP in 1998, three percentage points below the program target and more than six percentage points from the 1997 level. The good management of budgetary policy, in combination with a prudent monetary stance, also contributed to reduce the rate of inflation to 4.3 percent in 1998, half its level in 1997, in spite of the realignment of the escudo in March, 1998.

The authorities still face challenges ahead. Some aspects of Cape Verde's economy deserve special attention, including the country's low level of reserves (equivalent to 1.5 months of imports of goods and services in 1998), which, combined with a domestic banking system that still needs to be further strengthened, and prudential regulations that require additional improvement, make the economy vulnerable to external shocks. An adequate level of international reserves and a strong banking system, in combination with sound fiscal and monetary policies, are essential to sustain a credible pegged exchange rate regime such as the one in place in Cape Verde.

In this context, several recent developments in the domestic banking system are encouraging, including the increase of competition with the entry into operation of a new foreign bank, the improvement of the payments system, and the strengthening of the supervisory activities of the Bank of Cape Verde.

Also, the available indicators of the real effective exchange rate show that the country's competitiveness is adequate, as confirmed by the strong inflows of foreign direct investment and the strong increase of exports during 1995-97. It is very important that this competitiveness be preserved with prudent fiscal and monetary policies.

We concur with the staff's view that the budgetary stance for 1999 is in general appropriate, and we consider of utmost importance that the emergency public works poverty alleviation program be well targeted and its size maintained within reasonable limits, so as to avoid undesirable demand pressures. It is also encouraging that, as stated in Mr. Barro Chambrier's informative preliminary statement, the authorities are targeting an increase in outlays for recruitment of teachers and health personnel.

We welcome the lowering of the maximum tariff rate and the simplification of the tariff structure which will be introduced in the context of the customs tariff reform, as well as the possibility of adopting a value-added tax system within the next two years. Concerning the latter, the Fund must be ready to assist the authorities. We also welcome the acceleration of the privatization program in early 1999, after the slower than expected pace the previous year.

We commend the authorities for the progress made in improving the quality of statistical data, and we join the staff in urging them to continue their efforts in these areas and to give priority to updating the national accounts base. With these comments I support the proposed decision and wish the authorities every success in their future endeavors.

Mr. Azoulay made the following statement:

The authorities are to be commended on their remarkable economic achievements under the program. Most notable is the GDP that grew by 5 percent in 1998 and is expected to grow even more in 1999.inflation declined substantially to 4.3 percent in 1998. These outcomes are the result of the appropriate policy measures that the government has consistently implemented under the comprehensive program it adopted last year.

I share the staff's view that the authorities' challenge now is to consolidate the results achieved. The authorities should remain committed to the pursuit of macroeconomic policy aimed at enhancing stability. With the most stable macroeconomic environment, investor confidence will be encouraged and new private sector initiatives are likely to take place, contributing to increased economic activity and employment. Therefore, I urge the authorities to continue with their prudent monetary and fiscal policies directed at containing inflation, supporting the exchange peg, and improving the fiscal position.

One important element on the fiscal front is the domestic debt reduction operation. By creating an offshore trust fund with disbursement from multilateral and bilateral donors, together with privatization proceeds, the government would be able to swap high-yielding domestic bonds and reduce the debt service by almost 2 percent of GDP. Also worth noting is the need to thoroughly implement the privatization program and to completely privatize the 17 remaining enterprises. The establishment of a stock market, as well as the reform of the regulatory and judicial systems, will further enhance the private sector's role in the economy.

With these remarks, I share the thrust of the staff appraisal and support the proposed decision.

Mr. Santos made the following statement:

We welcome the renewed efforts to reduce macroeconomic imbalances in Cape Verde and put the economy on a path of sustained growth. We also support the authorities intentions to continue making these efforts in the framework of a Fund supported program.

On a more specific note, we would just like to stress the importance of achieving the convertibility of the Cape Verdian escudo through a sustained implementation of sound financial policies, which should be instrumental in preserving the economy's competitiveness. The benefit from a bilateral line of credit should be viewed as a temporary instrument to help achieving convertibility of the current account and support the new peg, until macroeconomic conditions and nominal variables in Cape Verde converge to Euro levels. In this respect, we are glad with the progress made towards liberalizing the trade and exchange systems, and the more reduced reliance on trade barriers and foreign exchange restrictions to support the peg.

Mr. Qi made the following statement:

It is encouraging to learn of Cape Verde's favorable economic performance under the Stand-by Arrangement. Economic growth remained robust, despite droughts in some areas. Inflation has declined. Efforts were also made to liberalize trade and exchange regimes, which have helped boost foreign investment and business confidence. The authorities' intention to consolidate these gains by continuing their prudent financial policies, and strengthening the tax system, budgetary procedures and the banking system, is most welcome. The delay in the domestic debt conversion program was unfortunate and the authorities are encouraged to complete the process in 1999. In this regard, I support the extension of the stand-by arrangement to end-1999 so as to provide some precautionary cushion to meet any contingent need for resources.

Since I broadly agree with staff appraisal, I shall focus my remarks on a few areas.

I note that the current account deficit of Cape Verde is very high at about 16 percent of GDP, even after including official grants. This warrants attention and continued monitoring in view of the exchange rate peg to the Euro. Nevertheless, the large current account deficit at present is due mainly to foreign-financed imports related to foreign direct investment and is not an issue of competitiveness. Coupled with rising remittances from migrants, the overall balance of payments position remains favorable. In order to ensure the external viability, efforts should be made to further diversify and strengthen exports, and develop tourism. Also, it is critical to provide a business friendly environment to continue to attract foreign investment and yet to ensure that foreign investment is channeled to the economy in an efficient way. Those flows hopefully should not be creating undue external liabilities, whether in the nature of debt or contingent liabilities. While staff have projected improvement in the current account balance over the medium term, the improvement is likely to be gradual and based on optimistic forecasts of exports and remittances from abroad. In view of the ongoing liberalization initiatives of the authorities, I wonder if the staff projections of the current account developments have already taken into account the impact of the further liberalization, as well as the profit remittance by enterprises following the injection of foreign equity.

On the fiscal policy, I agree with the staff that the emergency public works program should be well managed. I also welcome the authorities' prioritizing social expenditure. This is particularly important in view of the considerable size of the population below the poverty line. The authorities are encouraged to pursue domestic debt reduction in 1999 and support from the international community in this regard would be important to the successful implementation of the program.

I welcome the efforts made by the authorities to strengthen the banking system. The plan to enhance financial deepening by increasing competition in the system, developing money and bond markets as well as the stock exchange should help foster private sector development. To successfully achieve these goals, it is critical to put in place adequate supervisory capacity and an effective regulatory framework to ensure the smooth and efficient functioning of those financial markets.

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

The staff representative from the African Department, in response to the observation that the interest level still appeared high, said that the rate of inflation in the first three months of 1999 was negative, and there had recently been favorable data for April. The staff would remain in close contact with the authorities, who might be considering lowering the discount rate in the following few weeks.

On the question on the improvement of the statistical apparatus, appendix IV in the staff report indicated that there were some delays in strengthening government finance statistics, the staff representative remarked. However, there had been significant improvement in the national account preparations and, thanks to extensive technical assistance from the Fund, the balance of payments statistics. More generally, the authorities were benefitting from technical assistance in the statistical area, and they were placing priority on strengthening their statistical presentation.

On Mr. Qi's question on the possible impact of further import liberalization on the medium-term current account projections, the authorities considered the projections as relatively conservative and cautious, the staff representative informed. The projections were optimistic on export prospects in the coming years, because of significant foreign direct investment in the tourist and manufacturing sectors. Thus, on the basis of such information and trends, imports of goods and, in particular, services might be even more buoyant than presented in the staff report. There had been an increase in imports in 1997 and it was projected that a significant increase would occur in 1999 in connection with robust investment. The staff would continue to monitor closely developments relating to imports.

On the medium-term projections, it was somewhat difficult to be precise, but the staff would monitor the situation closely, the staff representative concluded.

Mr. Barro Chambrier said that his Cape Verdean authorities remained fully committed to the adjustment process, and he thanked Directors for their constructive comments and the staff for the understanding they had shown for the specific circumstances of Cape Verde and also for their useful advice. The authorities understood that more needed to be done to put the economy on the path of financial viability, which was why they intended to consolidate the results achieved during the year so as to attract more private investors. Thus, they considered that the initiative that to be put in place would contribute significantly to attract more foreign direct investment and to alleviate poverty that remained one of the major concerns of the authorities.

The Acting Chairman made the following summing up.

> Executive Directors agreed with the thrust of the staff appraisal. They welcomed the authorities' efforts to implement comprehensive structural reforms and improve the climate for private sector growth, while pursuing sound macroeconomic policies. They noted that, despite failing rains in a large part of the country, economic activity in 1998 had been sustained by the development of tourism, export-oriented manufacturing, and construction, supported by strong inflows of foreign investments. Inflation had been reduced, and continued to decline in early 1999. Directors commended the authorities for the considerable progress they had made in improving the fiscal position during 1998, and avoiding any recourse to domestic borrowing and bank credit.
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> Directors noted with satisfaction that the authorities had embarked on an ambitious privatization process that, if fully implemented, could be expected to lead to very large privatization revenues in 1999 and 2000. They welcomed the elimination of the quantitative import restrictions and the liberalization of foreign exchange regulations, which should facilitate the integration of Cape Verde into the world economy and encourage further foreign investment inflows. Looking ahead, Directors considered the medium-term outlook as favorable, but underscored the need, nevertheless, for sustained efforts to

consolidate the progress achieved in both the macroeconomic and structural areas.

Directors observed that, with the exchange rate pegged to the euro, it is essential that monetary policy be geared to bringing the rate of inflation to the level prevailing in the euro area and to strengthening the level of reserves of the central bank.

Directors emphasized the need to consolidate progress in the public finances in 1999, by continuing with prudent expenditure policies, and further strengthening the tax system and budgetary procedures. While they considered that the budgetary stance for 1999 was broadly appropriate, Directors stressed the need to ensure that the poverty-alleviating emergency public works program is well-targeted and its size maintained within reasonable bounds, with due regard for absorptive capacity. More generally, they suggested that efforts be made to improve the quality of expenditures. Directors considered it important that further progress be made in rationalizing the tax system, including the streamlining of the external tariff and the introduction of a value-added tax, which would contribute to broadening the tax base.

Directors noted that diversification of Cape Verde's export base was now giving notable results, and considered very encouraging the strong flow of foreign direct investment, which contributed to strengthening production and export capacity.

Directors regretted that the implementation of the domestic debt-reduction operation supported by Cape Verde's donors had been delayed until mid-1999. In this context, they underscored the importance of mobilizing rapidly the resources from the privatization program, to enable the timely contribution of Cape Verde to the resources for the debt reduction operation.

Directors welcomed the progress toward deeper, more competitive financial markets. They commended the authorities for the improvement of the domestic payment system, the strengthening of central bank prudential supervision, and their intention to sell the government's participation in the former state banks. Together with the development of the stock exchange, these steps would contribute to improving the allocation of savings and the effectiveness of financial flows.

Directors supported the authorities' policy of liberalizing the exchange system for current and capital transactions, and welcomed the authorities' intention to accept the obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement. In this context, they welcomed the elimination of the foreign exchange queue in mid-April 1999, and the measures envisaged to eliminate restrictions on travel allowances.

Directors urged the authorities to continue their efforts to improve the quality of statistical data.

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

The Executive Board then took the following decisions:

Cape Verde—Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Cape Verde's exchange measures subject to Article VIII, Section 2(a), in the light of the 1999 Article IV consultation with Cape Verde conducted under Decision No. 5392-(77/63), adopted on April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in EBS/99/71, Cape Verde maintains exchange restrictions in the form of limits on travel allowances that are subject to approval under Article VIII, Section 2(a). In the circumstances of Cape Verde, the Fund grants approval for the retention of the above exchange restrictions until June 30, 1999. (EBS/99/71, 5/6/99)

Decision No. 11962-(99/55), adopted
May 24, 1999

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

1. Cape Verde has consulted with the Fund in accordance with paragraph 3(h) of the Stand-By Arrangement for Cape Verde (EBS/98/18, Sup. 1), and paragraph 5 of the Letter of Intent of the Minister of Economic Coordination, with its annexed memorandum of economic and financial policies (the "Memorandum"), dated January 30, 1998.

2. The letter of the Vice Prime Minister, dated April 26, 1999, with the attached memorandum of economic and financial policies (the "April 1999 Memorandum"), shall be attached to the Stand-By Arrangement, and the letter dated January 30, 1998, and its memorandum shall be read as supplemented and modified by the letter dated April 26, 1999, and its annexed April 1999 memorandum.

3. Accordingly, the Stand-By Arrangement for Cape Verde shall be amended as follows:

(a) paragraph 1 of the arrangement shall be modified as follows:

"For the period from February 20, 1998 to December 31, 1999, Cape Verde will have the right to make purchases from the Fund in an amount equivalent to SDR 2,496,000, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund."

(b) paragraph 2(a) shall be modified to read as follows:

"Purchases under the Stand-By Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 2,400,000 until July 15, 1999 and the equivalent of SDR 2,448,000 until October 15, 1999;"

(c) the performance criteria on the net credit to the central government, and on the net domestic assets of the central bank, as referred to in paragraph 3(a)(i), and (ii) of the Stand-By Arrangement, shall include the limits for end-June 1999 and end-September 1999, as specified in Table 1 of the April 1999 memorandum, attached to the letter dated April 26, 1999;

(d) the performance criterion on the net foreign assets of the central bank, set out in paragraph 3(a)(iv) of the Stand-By Arrangement, shall be modified by replacing "central bank" with "banking system" and, for end-June 1999 and end-September 1999, respectively, shall be specified in Table 1 of the April 1999 Memorandum attached to the letter dated April 26, 1999;

(e) three new paragraphs, 3(e)(e)(e), 3(e)(e)(e)(e), and 3(e)(e)(e)(e)(e), shall be added after paragraph 3(e)(e) of the Stand-By Arrangement as follows:

"(e)(e)(e) after June 30, 1999, if the government has not effected the conversion of the equivalent of US$89 million of government securities into TCMFs (Titulos Consolidados de Mobilizaçao Financiera);"

"(e)(e)(e)(e) after November 30, 1999, if the government has not adopted the decree laws authorizing the privatization of ENAPOR, CABMAR/CABNAVE, and TACV;"

"(e)(e)(e)(e)(e) after September 30, 1999, if the government has not effected the conversion of the equivalent of EscCV 13.9 billion of government securities into TCMFs";

(f) a new paragraph 3(h)(h) shall be added after paragraph 3(h) of the Stand-By Arrangement, as follows:

"after October 19, 1999, until the review contemplated in paragraph 5 of the letter dated April 26, 1999, and paragraph 29 of the attached memorandum is completed."

4. The Fund decides that the second review contemplated in paragraph 3(h) of the Stand-By Arrangement for Cape Verde is completed, and that Cape Verde may continue to make purchases under the provisions of the Stand-By Arrangement, notwithstanding the nonobservance of the end-December 1998 performance criterion specified in paragraph 3 (a)(ii) and the performance criteria specified in paragraphs 3(e)(e) and paragraph 3(f) of the Stand-By Arrangement. (EBS/99/71, 5/6/99)

Decision No. 11963-(99/55), adopted
May 24, 1999

2. PAKISTAN—EXTENDED ARRANGEMENT—REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered a staff paper on the third review under the Extended Arrangement for Pakistan and its request for modification of the arrangement and waiver of performance criteria (EBS/99/72, 5/7/99; and Sup. 1, 5/21/99).

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

I would like to inform the Executive Board about information received this morning from Pakistan regarding developments in foreign currency deposits and the exchange rate since the unification of the exchange rate system.

Prior to the unification of the exchange rate, conversion to rupees from foreign currency deposits represented about US$3 to 4 million per day. In last four days there was some acceleration of conversion. On May 19, 1999, US$10 million were converted. On May 20, US$16 million, and on May 21 another US$10 million were converted. Finally, on May 22, US$31 million were converted. With the acceleration in conversion, there was some pressure in the kerb market, where the exchange rate depreciated from PRs#52.4 per US$1 prior to the unification to PRs#53.5 per US$1 following it. There was a simultaneous depreciation of the interbank market rate, which moved from PRs#50.8 per US$1 to PRs#52.1 per US$1. The central bank of Pakistan had intervened prior to the unification, but has not intervened since then, letting the interbank market find its own level based on supply and demand. It has, however, attributed the depreciation in the interbank market partly to the opening of letters of credit related to petroleum products, which amounted to US$35 million, which is half of the amount converted in foreign currency deposits.

Mr. Mirakhor submitted the following statement:

My authorities greatly value the close relations with the Fund. They wish to express their appreciation to the staff, management and the Board for their advice and continued support.

As the staff report brings out clearly, Pakistan's economy has performed well. Indeed, in some important respects, it has performed much better than could have been expected given the difficult circumstances. Fiscal and monetary policies have been kept on a tight rein; inflation has decelerated at a much faster rate than programmed; the external current account deficit is expected to be in line with the program, and with debt restructuring, is fully financed; gross foreign exchange reserves have been built up to more comfortable levels in spite of a faster than programmed pace of clearance of payment arrears; and a number of structural policy measures, the most important being the historic decision to move to a fully market-determined exchange rate, have been implemented ahead of schedule. As a consequence of these developments, market confidence is returning as evidenced by surging stock prices, upward pressure on the exchange rate and a diminishing premium vis-vis the kerb rate, and indications of renewed private capital inflows.

To be sure, there have been areas where performance has been less satisfactory. Once again, the all-important cotton crop has been badly hit by inclement weather and pest attack. This has hurt the economy's overall growth prospects and exports. Furthermore, the slow pace in activity, combined with the recent upturn in international oil prices, has adversely impacted on fiscal revenues and placed strains on the budget. The authorities have responded to these strains by taking a number of measures, including further expenditure cuts in nonpriority areas. There have also been important interest cost savings arising from the lowering in domestic interest rates. In any event, fiscal developments will be monitored closely so as to contain the budget deficit for 1998/99 to the programmed level of Rs136 billion.

While the immediate threat of a crisis has receded, the long term prospects remain difficult and there are no grounds for complacency. Indeed, the authorities recognize that much remains to be done if Pakistan is to recapture its historically high growth path, and combine stronger growth performance with employment generation, financial stability and external viability.

The budget for 1999/2000, which is due on June 12, 1999, will present a special challenge. Against the backdrop of the full year effect of the recently enacted cut in import tariffs, the unification of the exchange rate, higher world oil prices, and pressures to fund priority expenditure programs and grant a wage increase for the civil service, budgetary revenues will need to rise by a significant amount if the fiscal deficit target in the program is to be respected. This will not be an easy task but the authorities are fully committed to achieving the deficit target. Resolute action will be required to broaden the tax base through an extension of the GST to services, removal of the exemptions on electricity and petroleum products, as well as gas production and distribution, and fertilizers. Measures to strengthen tax administration, enforce the registration of the GST in those areas where coverage is not yet complete, and strengthen the GST refund system for exporters will also be taken. The authorities are also committed to introducing a common tax identifier on July 1, 1999. A new fixed surcharge on imported and domestically produced petroleum products is to become effective on the same day and will embody an automatic price adjustment formula that will ensure that the prices of petroleum products are responsive to movements in international petroleum prices and the exchange rate. Finally, and importantly, the budget will incorporate the first phase of the provincial land-based tax on agriculture income. While the initial revenue yield from this land-based system is expected to be modest, it will constitute a major reform measure with potentially far reaching implications for the structure, buoyancy and equity of the tax system in Pakistan.

Monetary policy is expected to remain tight, aimed at keeping inflation under control and supporting the new floating exchange rate. The monetary program does, however, allow for ample credit expansion to the private sector. The continued weakness in domestic demand growth and sharply falling inflation prompted the central bank to fine tune monetary policy in March 1999. With the move to a market determined, unified exchange rate, the authorities are aware of the importance of flexibility in interest rates as a signal of the stance of monetary policy. Recognizing that the effectiveness of the transmission of interest rate policy can be enhanced by addressing the issue of the high returns offered on the National Savings Schemes, the authorities, in the first instance, have cut the returns on these schemes by 2 percentage points.

The authorities are aware of the fact that if stabilization is to bring lasting benefit, it has to be underpinned by meaningful progress in the structural area. Accordingly, Pakistan's structural reform agenda is a wide-ranging one. It is clear that an improvement of the overall financial position of the seven major public enterprises hinges on a strengthening of the financial position of the Water & Power Development Authority (WAPDA). This has entailed many elements, including, inter alia, a tariff adjustment, a major tariff collection and theft reduction effort, and a metering program for agricultural consumers. The authorities plan to move forward expeditiously in this area in line with a program agreed with the World Bank which will be supported by a Power Sector Adjustment Loan (PSAL). The financial restructuring of Karachi Electric Supply Corporation (KESC) and implementation of agreements reached with the Independent Power Producers (IPPs) are being addressed in a satisfactory manner.

Important measures are also being taken to implement a modern supervisory framework for the financial sector along with stepped up efforts to enhance supervision of the commercial banks' management of new foreign currency deposits. The State Bank of Pakistan (SBP) has equipped itself with the means to monitor and intervene in the foreign exchange market. Continued significant progress in dealing with recoveries of defaulted loans has paved the way for bringing lending rates down and stimulating private sector demand and activity. Finally, the authorities remain strongly committed to implementing the Social Action Program (SAP) with a view to improving Pakistan's social indicators.

Mr. Shaalan submitted the following statement:

The policies embodied in Pakistan's reform program approved by the Board last January were considered by the staff to be less than optimal because of the then-prevailing difficult circumstances the country was facing. They held the view that there was no room for slippages in program implementation. The current review of the extended arrangement clearly shows that virtually all performance criteria and program targets were met and in a number of cases exceeded. The well-written and focused staff report documents the many accomplishments of the program during the latest period.

Important progress has, in particular, been made in reversing many of the restrictive measures introduced in the external sector which the authorities felt they needed to take, on a temporary basis, to address the external shocks that afflicted the country. We look forward to a satisfactory resolution of any remaining restrictive practices and particularly those related to the Foreign Currency Deposit (FCD) scheme and urge the authorities to reduce future reliance on this source to finance the balance of payments.

Other noteworthy policy accomplishments during the year have been evident in many other aspects of the economy. In the fiscal area, while the budgetary outlook is rather fragile, the fiscal target for 1998/99 is likely to be met. In this connection, we welcome the planned phased approach to expanding the coverage of the GST to services on July 1, 1999, and the subsequent removal of exemptions on electricity and petroleum products during the last quarter of this year. We encourage the authorities to extend the tax base to the retail level and to strengthen tax enforcement. This GST is an important measure in enhancing revenue collections from indirect taxation—a welcome development. While on the GST, we take note of and welcome the efforts to streamline the GST refund for exporters.

Another landmark development which has been on the drawing board for many years is the planned introduction in mid-1999 of a land-based tax on agricultural income. While the expected revenue target is modest, this step should be quickly followed by a broader approach to taxing agricultural income as a whole. We understand that work toward this end is under way and wonder if the staff can provide us with any additional information on progress and revenue expectations from this tax.

On monetary policy, we applaud the State Bank of Pakistan for the important progress achieved in strengthening the prudential, supervisory, and regulatory framework of the banking system, reducing nonperforming loans, and the work in progress directed at preparing nationalized banks for privatization. We also strongly concur with proposals directed at enhancing the financial integrity of public sector financial institutions. In particular, we would underscore the staff recommendation that all credit to the private sector must come under the supervision and control of the State Bank. As the Asian crisis has taught us, continued strengthening of the banking system should rank high on the authorities' priority list.

The credible perseverance of the recent past in addressing the many daunting problems facing the country are worthy of commendation. We fully support the authorities' view that there are risks ahead necessitating continued deepening of the reform effort. The welcome signs of restoration of confidence are clearly apparent—these include the behavior of the stock exchange, capital inflows as well as the stabilization of the exchange rate, and strengthening of the balance of payments. We encourage the authorities to build on the recent achievements and close the book on past policies of "stop-and-go" reforms.

Finally, two areas that deserve special mention as Pakistan moves forward in its reform program are: the budget and structural reform of the public sector including, in particular, the power sector.

For many years, the budget has been at the center of many of Pakistan's problems. Rightly, the present program is directed not only at reducing the consolidated budget deficit in the period immediately ahead but, more importantly, the emphasis has been on putting in place a set of structural fiscal reforms aimed at improving the fiscal process by broadening the tax base and enhancing revenue elasticity so that there will be less reliance on annual ad hoc tax measures, as well as implementing credible and forceful measures to ensure revenue compliance and collection. These are important medium-term objectives, which, if implemented, will finally give Pakistan a viable and sustainable budgetary outlook. For the immediate future, however, and in view of the special factors that contributed to the attainment of the projected deficit target for 1998/99, the deficit target for the coming year at 3.3 percent of GDP is indeed an ambitious one. If I am not mistaken, a deficit of this magnitude would be the lowest attained in Pakistan's recent history. Meeting this target would add considerably to the credibility of the country's policies and further enhance the emerging confidence.

The other area that merits the authorities' attention is the long-awaited reform of the public sector and, in particular, WAPDA, and the power sector. Strengthening the financial performance of the Authority and enhancing its efficiency will contribute in a meaningful manner not only to budgetary improvements but will also improve the financial position of a number of public enterprises, including in particular a number of major energy corporations.

We fully support the proposed decisions and wish the authorities continued success.

Mr. Sivaraman submitted the following statement:

At the outset, we would like to commend the authorities for the satisfactory macroeconomic performance during the current fiscal year, with the growth projected to be at least 3 percent for the year, inflation remaining at a modest level, and a build up in the official foreign exchange reserves. Notwithstanding the difficult economic environment prevailing in the country, the authorities took bold initiatives in implementing the reform program. They should be commended for the steadfast implementation of policies in conformity with the program commitments and observing all quantitative performance criteria. The non-observance of the performance criterion relating to the Petroleum Development Surcharge (PDS) on account of the PDS rate for the fuel oil remaining below the band can be waived as the authorities are taking necessary steps to move towards an automatic price adjustment mechanism which will reflect the changes in international petroleum prices and developments in the exchange rate. As I am in broad agreement with the thrust of the excellent staff paper, I would be brief.

The key to the success of macroeconomic stabilization in Pakistan will be in addressing the problems in the area of fiscal consolidation and restructuring of the budget. I agree with the staff that substantial effort will be required to achieve a growth of more than 20 percent in the tax revenues and reduce the deficit to 3.3 percent of GDP in 1999/2000 from the revised program level of 4.5 percent in 1998/99. As I had mentioned in my statement for the Board meeting held in January, 1999, the authorities would have to reorder the budgetary priorities to make the fiscal deficit manageable. If we look at the table 3 of the staff report, current expenditure on interest and defense alone accounts for 11 percent of GDP in the revised program for 1998/99 against the CBR revenue and total tax revenues of 9.9 and 13.1 percent of GDP respectively. If the expenditure on interest and defense accounts for most of the tax revenues and exceeds the CBR revenue, there will be little scope for containing the fiscal deficit. However, in the medium term scenario presented in the table, the fiscal situation is projected to improve from the next financial year with the expenditure on interest and defense remaining below the CBR revenue. We are encouraged to note that the authorities are taking steps for broadening the base of GST and improving its operations following the recommendation of the Fund technical assistance mission. The extension of GST in most of the services in two phases beginning on July 1, 1999 will be a major step and will considerably strengthen the revenue base. This will provide more room for enhancement of expenditure in the priority social sectors such as health, education and rural development and critical infrastructure projects.

We are encouraged to note that the authorities are approaching the tax on agricultural income in a practical manner. The decision to adopt a land-based system of taxation throughout the country which will be modeled along the lines currently in place in Punjab province is sound. In my view, the upgrade of the existing system of land revenue in the sub-continent, which is based on the presumptive income of agricultural land linked to the land productivity, is the most practical approach to taxation as compared to imposing a regular tax on agricultural income.

We are happy to note that the authorities are taking measures to strengthen the tax administration and planning to take forceful action in enforcing registration of the GST in several key sectors including retail and textile sectors. The target to assign the Common Tax Identifier (CTI) to the 60,000 largest firms by July 31, 1999 is quite ambitious given the informal nature of many textile and retail units and would require sufficient preparation for its success. It is encouraging to note that legislation has been passed to remove the powers of the government to grant exemption under the GST and customs duties.

We welcome the abolition of multiple exchange rate system and move to a market-determined exchange rate regime. With the weights of the composite rate of the inter-bank rate and the official rate changed to 95 percent and 5 percent respectively in March, 1999, the authorities had moved decisively towards a market-determined unified exchange rate. The stabilization of currency since the end of 1998 and a steep decline in the kerb market premium have facilitated a smooth transition to a floating exchange rate system.

We agree with the staff appraisal that the setting of interest rates will now gain in significance for signaling the stance of monetary policy under the new floating exchange rate regime. In this regard we share the concern of the staff that the administered interest rates on instruments like National Savings Scheme (NSS) are high as compared to the yields on market-based instruments of comparable maturities offered by the banking sector and they need to be adjusted accordingly. It is encouraging to note from the statement of Mr. Mirakhor that the authorities have, in the first instance, cut the returns on these schemes by 2 percentage points. The authorities should also expeditiously resolve the problem of the still large stock of Foreign Currency Deposits (FCD).

This chair appreciates the steps taken by the authorities in carrying out structural reforms, both in the financial and non-financial sectors. Pakistan has made significant progress in the cash recoveries of the defaulted loans in recent months and the target of reducing nonperforming loans from about 18 percent of banks' portfolio at present to 10 percent by 2001/02 will enhance the financial viability of the banking system. We also commend the authorities for the passage of Banking Companies Amendment Bill in January, 1999 which will strengthen the supervisory capacity of the SBP in determining capital adequacy of banks and enforcing disclosure and prudential regulations.

It is satisfying to note that there is progress on the privatization front. What has the staff advised the authorities on the use of privatization proceeds? It should, in our view, be applied to the reduction of debt rather than to reduce the fiscal deficit. On the structural front, there is a need to settle the WAPDA disputes quickly with the government. as well as with the IPPs. On the external sector side, there is a need to look at the unidentified capital outflows which have not been fully explained in the footnote 4 on page 4 of the staff paper.

In recent weeks, news items have appeared on a regular basis highlighting the possibility of Pakistan defaulting on its international bonds, as a result of comparability of treatment requirements from the Paris Club. It is, therefore, important that the authorities should speedily resolve the issue.

With these remarks, we would like to support the proposed decisions and wish the authorities all success in their future policy endeavors.

Mr. Harinowo and Mrs. Vongthieres submitted the following statement:

We wish to record, at the outset, our support for the completion of the third review of EFF for Pakistan and the request for waiver and modification of structural performance criteria. Many doubts were expressed at the last Board meeting concerning the strength of the program and the ability of the Pakistani authorities to keep on track the required policy measures. The authorities, nonetheless, have demonstrated their perseverance and strong commitment as reflected in the observance of all quantitative performance criteria and the significant progress on structural reforms. Their efforts are commendable.

Macroeconomic performance continues to be impressive, with sustainable growth driven by the manufacturing sector, and better-than-projected inflation and improvement in the external balances as regards both the current and capital accounts. Gross official reserves have substantially strengthened, following the disbursement of official aid and the reflow of private medium-term capital as investor confidence has resumed. This, together with the debt relief from the Paris Club, helped narrow significantly the financing gap for the year 1998/99.

We are pleased to note the improved economic outlook for 1998/99, despite the worsening prospects for exports. It is surprising, however, to see the downward revision of the inflation rate by three percentage points from the last discussion, despite the recent price pickup, the reduction in the repo and treasury bill rates, the increase in petroleum product prices and electricity tariff, the withdrawal of electricity subsidy, and the pay increase for the civil service and the armed forces.

On the fiscal side, while the government was able to maintain the budget deficit within the program ceiling for July-December 1998, it should move urgently and more systematically to correct the shortfalls in tax revenue if the ambitious goal for fiscal consolidation is to be achieved and sustained over the medium term. In this respect, we welcome the government's recent measures to broaden the GST system and streamline GST procedures, as well as its contingency plan to cut low-priority non-social expenditure projects. Focus should be on the revenue side, however, and much remains to be done in the area of tax reform to enhance revenue collections, particularly strengthening tax administration, reducing GST exemptions, and broadening the tax base. Under the present tax system, not only is the economy considerably under-taxed, but the taxation is also far from neutral. We urge the authorities to press ahead with the comprehensive review of the tax system and to give serious consideration to the equity issue in the treatment of tax across sectors. planned introduction of land-based agricultural income tax is an important step in the right direction.

As a result of the tightening of monetary policy since November last year and a reduction in government borrowing from the banking sector, monetary expansion slowed down considerably to below the target level. It is, nevertheless, our concern that credit to the private sector has slowed while bank liquidity remains relatively high. Yet, any step by the central bank to stimulate private credit demand through interest rate policy will have to be taken with caution, taking account of the potential impacts on the exchange rate and the conversion of FCDs into rupees.

In the foreign exchange market, confidence has returned gradually and the exchange rate has stabilized. We are encouraged by the progressive relaxation of exchange restrictions--the stepped reduction in the import deposit requirement and its elimination altogether ahead of schedule. Most important, we applaud the authorities' historic move to abolish the official exchange rate and adopt a market-based unified exchange rate system two days ago. We would like to know about the reaction from FCD holders and would appreciate the staff's assessment of the present exit strategy including the accommodating measures taken to facilitate FCD conversion. Measures to restrain the withdrawal of FCDs afterwards may not be desirable as they could hamper investor confidence in the future.

We join the staff and other Directors in commending the Pakistani authorities for the significant progress made in structural reforms, in particular the strengthening of the banking system soundness and supervisory framework, preparations for privatization, and trade reform. In the power sector, we welcome the several measures taken to improve the financial position of WAPDA and the planned restructuring and corporatization as agreed with the World Bank. We can only urge the authorities to speed up the process.

On external debt, it is reassuring to note that the Paris Club earlier agreed to reschedule Pakistan's $3.3 billion debt, and also that agreement on the restructuring of $510 million debts to commercial banks is being worked on. It is hopeful that both sides could agree on the terms that are favorable to Pakistan so as to sufficiently provide the country with the cash flow relief and allow the authorities to concentrate more on reviving the economy and necessary structural reforms. restructuring of sovereign bonds is more complex and the international community is watching this test case of Pakistan. We hope that some form of compromise can be reached to the satisfaction of the Paris Club creditors. country cannot be denied official assistance after it has pursued in good faith negotiations with bond holders.

Lastly, we would like to commend the staff for the candid report and hope to see any existing contentious issues being resolved before the next review. We also wish the Pakistani authorities further success in carrying out the difficult tasks ahead.

Mr. Portugal submitted the following statement:

Pakistan's recent economic developments have been encouraging compared with program objectives. As Mr. Mirakhor's statement clearly emphasizes, policy implementation conformed to program commitments and enabled the authorities to comply with quantitative performance criteria. We commend them for their achievements.

We welcome the recent implementation of the unified exchange rate system, as well as the envisaged fiscal consolidation to stabilize public debt and release resources for private sector development. We found that the updated medium-term framework is predicated on continued tight demand management policies and acceleration of structural reforms. On the structural side, we support the fact that fiscal reforms will focus on the extension and strengthening of the tax base. Measures to enhance tax administration, enforce the registration of the GST in those areas where coverage is not yet complete, and strengthen the GST refund system for exporters need to be taken. Also, we found appropriate the commitment to finalize the key elements for an appropriate agricultural income tax and welcome the inclusion on the budget of the first phase of the provincial land-based tax on agricultural income. We would like to reiterate that the authorities need to concentrate on maximizing the effectiveness and development of public expenditures, taking into account the need to safeguard the Social Action Program and to ensure the Public Sector Development Program. In the financial sector, we recognize the important progress in improving the SBP's supervisory capacity, and we encourage the authorities to enhance the financial integrity of public sector financial institutions to provide the basis for their privatization. It is important to note the important progress that the authorities have made in normalizing relations with creditors. As the staff mentioned, we found imperative for the authorities to move expeditiously in concluding bilateral agreements with Paris Club creditors and all other bilateral, commercial, and private creditors.

As the staff clearly explains, the macroeconomic situation remains vulnerable, especially in the current external environment. Export earnings depend highly on cotton manufactures, and foreign capital access may take some years to be rebuilt completely. We recognize that the program takes into account the current economic circumstances of Pakistan, as well as the ability to implement them. Full implementation of the program should improve public finances, encourage private sector activity, and contribute to better economic performance. In this context, we can support the proposed decisions and welcome the strong commitment of the authorities to a timely and full implementation of their structural reform program. We would like to wish the authorities every success in their endeavors.

Mr. Kiekens and Mr. Nemli submitted the following statement:

It is good news that all performance criteria fore end-December and end-March were met, as well as all but one structural benchmark. However, this encouraging performance is marred by major weaknesses in tax collection. Stagnant government revenues are the root cause of Pakistan's severe economic problems and contribute to Pakistan's external vulnerabilities. Meeting the program's tax revenue targets is a key indicator of the authorities' ability to implement the program. This makes the significant shortfalls in income tax and customs revenues worrisome. Increasing tax revenues is crucial to program success. Given persistent weaknesses in tax collection, we suggest that the target for the revenues of the Central Board should become a performance criterion. We urge the staff to negotiate such a change in the program during the next review mission.

There is little comfort in the fact that the budget deficit was on target. The earlier-than-envisaged dividend payment by the Pakistan Telecommunication Company and the reduction of current expenditures merely offset the shortfall in tax revenues. The early dividend payment reduces by an equal amount the non-tax revenues to be expected later, and the restraint of spending cannot be sustained.

The authorities' deficient tax collection during the first half of FY 1998/99 has made it necessary to lower the program's tax revenue target for the whole year. With the new target of 13.1 percent of GDP, tax revenues will be one percentage point of GDP lower than three years ago. For next year, however, the tax revenue target has been held constant in GDP terms, notwithstanding this year's slippage. This is commendable, but the authorities should be aware that this year's slippage will make it harder to meet next year's target.

The most important challenge is to broaden the tax base. To accomplish this, the GST should be extended to services, the agricultural sector should be taxed, the GST exemptions should be removed, and GST registration should be rigorously enforced. The GST tax base and collection system and base were considerably strengthened in the first half of FY 1998/99, but many potential taxpayers have still to be registered. To increase compliance in key sectors, the authorities must vigorously enforce GST registration, especially in the retail and textile sectors where coverage is not yet complete.

The authorities intend to extend the GST to services, and to remove the GST exemptions for electricity, gas, and petroleum products. Strict observance of this schedule is of paramount importance. We urge the authorities to proceed faster than scheduled under the program. Enacting legislation to eliminate the government's power to grant exemptions from GST and customs duties will boost tax revenues. However, these gains are threatened by the introduction of fixed tax schemes and trade enrollment schemes for taxpayers. These schemes are a breach of a structural benchmark under the program and should be eliminated.

Changes in international petroleum prices and the exchange rate must be passed on to consumers. This will prevent the prices of petroleum products from being subsidized with budgetary revenues. This requires introducing an automatic price adjustment formula as soon as possible, even ahead of the program schedule.

Let us now comment on budget expenditures. The staff advises that defense spending be further contained, but we would urge the authorities to reduce it. The financial weaknesses of WAPDA is a major threat to the budget. The government is confident that WAPDA's need for budgetary support will be eliminated by timely payments from the government for its electricity consumption and by forceful implementation of WAPDA's restructuring program. However, past reforms intentions have failed to materialize, and for the sake of prudence the budget should contain contingency measures against this specific risk.

Pakistan's social fabric is fragile. Fiscal slippages should therefore not be corrected at the expense of critical social expenditures. We strongly regret that the substantial shortfall in provincial budgetary resources early this fiscal year is straining the Social Action Program (SAP), and has caused shortcomings on social policy targets agreed with donors.

We commend the authorities for moving early to a unified, market-determined exchange rate. The shift to a floating exchange rate system makes interest rate adjustments the primary instrument of monetary policy. We urge the authorities to eliminate the market segmentation caused by the administered interest rates on National Saving Scheme instruments by making them the same as yields on market-based instruments of comparable maturities offered by the banking system.

Finally, we reiterate the need to improve the financial performance of public sector enterprises, especially in the power sector. WAPDA's comprehensive restructuring must not be delayed any further.

Mr. Al-Turki made the following statement:

I am encouraged by Pakistan's performance under its economic program. The better than expected inflation picture and higher than programmed reserves are particularly welcome. This improvement could not have been achieved without the authorities adherence to the agreed policies, as evidenced by the achievement of all quantitative performance criteria for end-December and end-March. The challenge now is to sustain the adjustment effort and address the structural roots of the economic imbalances in order to place the economy on a sustainable growth path.

On fiscal policy, I am encouraged by the progress made in extending the GST coverage and removing exemptions. Such efforts should broaden the tax base and remove the inefficiencies that Pakistan can ill-afford. The progress made in restructuring the WAPDA should also strengthen the fiscal position and enhance efficiency.

That said, weaker than anticipated revenue performance underscores the need for greater vigilance in fiscal consolidation. In this regard, the corrective steps that have been implemented highlight the authorities' commitment to achieving the fiscal targets in 1998/99. It is critical that this commitment be sustained, given the large fiscal consolidation effort needed in 1999/2000. Indeed, achieving the revenue target requires resolute and timely implementation of the agreed measures, especially the strengthening of tax administration, further broadening of GST coverage and the tax on agricultural income.

In the monetary and credit areas, I agree with the staff that much slower than programmed monetary expansion indicates that policies were relatively tight. In this regard, I welcome the reduction in the repo rate in March 1999. Indeed, in view of the downside risks to growth, it is important that adequate credit is available to the private sector and that monetary policy does not remain too tight. It is also essential to accelerate efforts to increase the flexibility of interest rate determination on the National Saving Schemes.

Turning to the external sector, let me start by welcoming the unification of the exchange system ahead of schedule. I also welcome the improved medium-term outlook of the external current account. It is essential, however, that Pakistan continues its efforts to reschedule and restructure its debt.

To achieve the full potential of the macroeconomic adjustment efforts, the authorities need to continue to press ahead with structural reform. Additional reforms of WAPDA and the financial sector are especially important. Here, I welcome the improved recovery of defaulted loans in public sector financial institutions. I am also encouraged by the progress made in the preparations for the privatization of three commercial banks as well as a number of large companies. It is important, however, to continue pressing ahead with privatization in the coming year. As for trade reform, I welcome the reduction in the maximum tariff rate and in tariff bands. Further efforts, however, are still needed.

With these remarks, I support the request for waiver and the completion of the review and wish the authorities all the success.

Mr. Hendrick made the following statement:

It is fair to recognize the authorities' efforts to keep their economic program on track despite the adverse external conditions. Economic growth is maintaining momentum, inflation has been contained to one digit in 1998/99, far below the almost 15 percent envisaged in the program, and gross reserves have been accumulated at a faster path than anticipated. I concur with the staff that the authorities deserve credit for these developments and for meeting all quantitative performance criteria for end-December 1998 and, as described in supplement 1, all quantitative and most of structural performance criteria at end-March 1999.

The authorities have also made important progress in banking reform and in developing the agricultural income tax, prepared the nationalized banks for privatization and enhanced the supervisory capacity of the State Bank of Pakistan (SBP). I commend the authorities for the recent unification of the exchange rate market. These actions will contribute to the ongoing process of restoring market confidence and the economy's ability to resume growth to its full potential.

Nonetheless, the fiscal position is still fragile, some constraints remain for monetary policy implementation, the financing of the external current account deficits still poses some questions, including the restructuring of the eurobonds, and there is still a long way to go in the structural reform process. As I broadly agree with the thrust of the staff appraisal, I will confine my remarks to these four points.

The vulnerability of the fiscal revenues and the narrowness of the tax base are issues that need to be addressed forcefully if the authorities intend to maintain their current fiscal deficit targets under the program. In this regard, I welcome their commitment to extend the General Sales Taxes (GST) and remove current exemptions for electricity, gas, and petroleum products. I also welcome their important decision to carry out a uniform provincial land-based tax on agricultural income. Efforts to provide an appropriate legal framework and an efficient implementation for both initiatives should be a priority.

On the other hand, looking at the budget for 1999/2000, I am concerned about the weakening of tax revenue collections and the downside risks to the budget arising from weaknesses in WAPDA's finances. There is limited room for reducing further non-interest current expenditure and there is a need for more financing to the social safety net. Like Mr. Shaalan, I believe that the fiscal deficit target for the next year is an ambitious one. In this context, I would like to ask the staff about the feasibility to carry out their suggested policy recommendations to increase taxes and contain expenditure or whether a redefinition of the fiscal targets under the program would be needed because of the constraints to sustain the current fiscal program.

On monetary policy, to provide for a positive credit expansion to the private sector, limiting the massive public borrowing from the banking system in previous years is important. Market mechanisms should be designed to increase the low demand for credit by the private sector while protecting the quality of the loan portfolio of the banking system.

I concur with the staff that, after the unification of the exchange rate market, interest rate policy has to play an important role in the framework of a money-based nominal anchor policy. In this regard, a review of the National Saving Schemes (NSS) interest rates to make them consistent with yields on market-based instruments of comparable maturities offered by the banking system is essential. As explained in Mr. Mirakhor's helpful statement, the first step taken by the authorities to reduce in two percentage points the returns on these schemes is encouraging.

I share the authorities' arguments for the Foreign Currency Deposit (FCD) exit strategy. However, I also think that trying to set a clear time frame for a final resolution of the FCD issue which is still imposing some uncertainties on the exchange rate and monetary policy is important. Moreover, it is likely that after the unification of the exchange rate, in fact, conversions could lead to some substantial pressures on the exchange rate. I am looking forward for the review of this matter in the next Board meeting.

Turning to the external sector, I welcome the increase of foreign reserves beyond the level envisaged in the program and the implementation of trade reforms at end-March 1999. The sizeable increase in private medium-term capitals, in relation with the program, is encouraging reflecting the increase in market confidence and the successful agreement with the Paris Club creditors.

However, looking at tables two and six of the staff report: balance of payments and external financing requirements, it is clear that the viability of the medium-term financing of the current account deficit, requires not only a successful completion of Paris Club rescheduling, but also a substantial increase in the net private medium-and-long term flows (foreign direct investment and portfolio investment), and a strong reversal of the private short-term outflows.

In this context, and taking into consideration the staff concerns reflected in paragraph 12 of the paper "Involving the Private Sector in the Resolution of Financial Crisis-Bond restructuring": "[... securing new money on appropriate terms would clearly be preferable to a bond restructuring, and would avoid jeopardizing access to other sources of private capital, such as trade and project related credits and inward direct investment"], it is not clear to me whether the rescheduling of the Eurobonds in terms similar to the Paris Club agreed Minute would help to attain the overall financing requirements under the program.

Let me be clear. This chair supports the principle set by the Board that the private sector should be involved. However, in our view, this involvement should be in a voluntary basis. Moreover, Fund supported programs should not condition its resources to such an outcome. We cannot rule out the risks associated with a lowering of the credit rating and the ability and cost of the public and private sector to borrow in the global capital markets and attract new investments to Pakistan.

Finally, the structural reform continues to be the cornerstone of the program. I welcome the important progress in the privatization process and the reform in the fiscal sector, in particularly the design of the income tax on land. However, in our view, it is important to press ahead with the completion of the restructuring plans for the Water and Power Development Authority (WAPDA) which is the biggest public enterprise. The agreement reached with the provinces and the federal level on procedures to enforce electricity bill payments within 45 days is encouraging, as well as, the completion of the reconciliation of the outstanding unreconciled amount of the current fiscal year's billing.

I encourage the authorities to attain their objective to reduce nonperforming loan ratios from 18 percent at present to 10 percent by 2001/02.

With these remarks, this Chair endorses the proposed decision and wishes the authorities every success in their endeavors.
Mr. Luo made the following statement:

The Pakistani authorities are to be commended for their impressive macroeconomic performance in late 1998 and early 1999 and their full observance of the quantitative criteria for end-December 1998 against the background of external uncertainties and unfavorable weather conditions which have reduced the agriculture output, one of the engines of the Pakistani economy. The growing confidence, evidenced in the stock and the foreign exchange markets, is indeed an indication that the economy may enter a new phase of sustained economic growth.

Nevertheless, in order to ensure the sustained economic growth, much needs to be done. The staff has listed many of tasks ahead and I share its appraisal. Here I would like to offer some thoughts on the need to reduce the rather high external debt ratio and the fiscal reforms.

I take note that the external debt to exports ratio in 1999/2000 will be almost 300 percent, and 281 percent in 2000/01, after taking account of the Paris Club debt relief and 250 percent until 2002/03. This high ratio, even higher than that in some HIPC Initiative cases, reflects the heavy external debt burden which consumes a large amount of precious resources that could have been used for economic development. In my view, joint efforts by the authorities and the international community are needed in lowering this ratio. I welcome the debt rescheduling offered by the Paris Club and the recent agreement reached between the authorities and some commercial banks. In my view, further assistance is needed from the international community in this regard. On the part of the authorities, the development of an export-oriented strategy will be crucial. I think the adoption of fiscal, monetary and exchange rate policies by the authorities that aimed at promoting exports is in the right direction and a coherent industrial policy will strengthen this strategy.

The fundamental settlement of the external debt points to the need of keeping the fiscal account in good order. Although the budget deficit during the first half 1998/99 was kept on target, the lower than programmed tax revenue is still a source of concern. It is encouraging that significant progress has been made on the strengthening of the GST and the authorities are committed to further broadening it. I also agree with the staff's view that tax enforcement and the administrative capacity of the CBR should be further strengthened. I welcome the authorities' commitment to maintaining an appropriate level of petroleum taxation to ease the fiscal implications of the exchange rate unification. I support the introduction of the fixed surcharges on petroleum products and the waiver for nonobservance of the performance criterion related to the PDS. The progress in strengthening the system of taxation on agricultural income at the provincial level is welcome. In view of the importance of the agricultural sector in the economy, we should bear in mind that all means of strengthening agricultural taxation should be beneficial to agricultural production. Prudence may be still needed in this regard.

With these comments, I wish the authorities every success.

Mr. Santos made the following statement:

We welcome the opportunity to review the Extended Arrangement for Pakistan. Progress under the arrangement has been broadly satisfactory, with fiscal and monetary policies being generally on track. Pakistani authorities have also made substantial progress in dismantling the emergency measures that were adopted in the aftermath of the economic sanctions following the nuclear test. We welcome in this respect the move to a market-determined exchange rate. We also wish to commend the decision to allow WAPDA to negotiate directly with the independent power procedures. This measure by itself is bound to lift investors' confidence. We must however, once again, emphasize that the efforts to address the structural weaknesses of the Pakistani economy are discomfortingly limited. We would now focus our comments on two areas, namely tax policy and trade liberalization.

On tax policy, we believe that structural weaknesses in the tax system remain a major source of concern. With significant shortfalls in income tax and custom duties, the budgetary target was met mainly because of an earlier-than expected dividend payment. If, as it seems likely, this event is not repeated, future budgetary achievements could well be at jeopardy. The poor tax performance highlights the need for structural reforms. The proposed remedies (further cuts in spending, lower debt-service payments, higher profit transfer from the SBP) fall short of this requirement. In this respect I would make three points:

First, agricultural taxation is a crucial step in the process of broadening the tax base. We take note of the authorities commitment to take concrete measures in this area in the next few months and urge them to proceed with utmost determination.

Secondly, we believe structural weaknesses in the public enterprise sector represent a constant threat to the budget. In particular, slower than projected growth will lead to a decline in revenues for WAPDA. We fear that additional losses by WAPDA are likely to have a non-negligible impact on the budget.

Thirdly, the taxation of petroleum prices (which is associated with the violation of a performance criterion) will be soon reformed with the introduction of a fixed surcharge (i.e. a specific tax) on petroleum products. With a relatively elastic demand, however, a specific tax means that any increase in world oil prices will lead to a fall in revenues. Petroleum taxes are an important source that ought to be protected. We would like to know from the staff whether they have considered alternative modalities for taxing petroleum products and why a specific tax was chosen in the end.

Finally, with regard to trade liberalization, we welcome the reduction in the maximum tariff rate from 45 percent to 35 percent. This is an important step in what is still a long way toward a liberal trade regime. We should recall that only two years ago Pakistan was rated as having one of the most restrictive trade regime. Lowering the maximum duty rate may contribute to make trade policy somewhat more liberal. Yet, it is difficult to gauge the impact of this measure on the restrictiveness of the trade regime without additional information. We would be grateful if the staff could inform the Board on the evolution of both mean tariff rate and its dispersion. These are far more revealing indicators of the stance of the trade regime. We are also concerned by the way Pakistani authorities have reacted to the fall in the international price of a number of agricultural products. Raising duty rates in response to a fall in world prices can only strengthen the anti-export bias of the trade regime.

To sum up, we wish to congratulate Pakistani authorities for the progress made in eliminating the restrictions on trade and payments imposed one year ago. However, we would submit that IMF financing should not be used mainly to dismantle measures that were adopted to respond to an economic emergency, however distortionary these measures might have been. Returning to the initial distorted situation is not satisfactory. IMF programs are designed to address the fundamental weaknesses of the economy that hamper its growth perspectives. Judged on this ground, however, Pakistan is still far from being a success story.

Having said that, I can support the request for waiver and modification of structural performance criteria. I wish the authorities all success in their future efforts.

Mr. Barro Chambrier made the following statement:

I commend the staff for their candid and well-focused paper. I also commend the Pakistani authorities for their adherence to sound policies, which have enabled them to meet all the quantitative performance criteria in the program. Macroeconomic performance has significantly improved, steps have been taken to advance structural reforms, and business confidence is being restored as evidenced by the lifting of exchange restrictions and the build-up of official reserves. These achievements notwithstanding, I share the view that the economy of Pakistan remains fragile and vulnerable to external shocks. However, I am reassured by Mr. Mirakhor's statement that the authorities will continue to implement sound policies and structural measures, which are indispensable if the economy is to be put on a sustainable growth path, reduce further financial imbalances, and improve living conditions in Pakistan. These are commendable objectives and I strongly encourage the authorities to persevere in their adjustment process and to avoid any stop-and-go policies.

I share the thrust of the staff appraisal, and shall limit myself to a few remarks for emphasis. I commend the authorities for the swift implementation of various measures to offset the revenue shortfall in the first half of 1998-99. As some of those measures were of an ad hoc nature, I strongly encourage the authorities to carry out vigorously the tax reforms that can bring about major and lasting improvement in budgetary revenue. These include a further strengthening of tax administration, especially the Central Board of Revenue, a broadening of the general sales tax as recommended by the Fiscal Affairs Department's mission, and the implementation of the first phase of the land-based tax on agricultural income. I encourage the authorities to carry out the necessary preparatory work on the last two reforms, including a communications campaign and seminars to ensure that those reforms will proceed as scheduled and that their objective will be fully met. The authorities should also ensure that all adjustments related to exchange rate developments are passed through to consumers in a timely manner, so as to protect budgetary revenues. In that respect, the automatic adjustment in the price of petroleum is welcome.

Further reduction of low priority expenditure outlays should be sought in order to meet the basic needs of education and health and to improve weak social indicators. In this regard, the pursuit of a prudent wage policy and further cuts in defense outlays are highly recommended. The achievement of the projected fiscal deficit of 3.3 percent of GDP in 1999-2000 will require increasing revenue mobilization efforts and continuing the prioritization of public expenditures. The manner in which the budget for 1999-2000 is prepared will be important if those fiscal targets are to be met. Could the staff indicate the main changes in the draft budget?

Pakistan has made a courageous decision to move to a fully market-determined exchange rate. I also welcome the reduction in the interest rate of the National Saving Schemes and encourage more flexibility in the determination of interest rates in order to enhance the effectiveness of monetary policy.

Significant progress has been recorded on structural reforms, but much remains to be done. Sustained efforts are needed to reduce the still large portion of nonperforming loans in the banks' portfolios. Could the staff elaborate on the measures in place to reduce nonperforming loans?

The financial relationship between the water and power development authority and the central and local governments must be rationalized and the budget for public consumption prepared in a transparent manner. The prior actions already implemented are appropriate, but more is required to accelerate the restructuring of the water and power development authority and to reduce its burden on the budget and other enterprises.

Although the risk of policy slippage has diminished, Pakistan faces difficult challenges. It is, therefore, important to develop statistical data for close monitoring and to continue strengthening program ownership thron tax identifier, revenue mobilization, expenditure management, and the agenda of structural reforms.

I support the proposed decision, and wish the authorities continued success in their adjustment process.

Mr. Gobe made the following statement:

The fact that the Pakistani economy is being stabilized steadily is much appreciated. The foreign exchange market has stabilized and inflation has subdued. In addition, I welcome that there has been some progress made on structural reform. The electricity subsidy was reduced, and the Banking Companies Amendment Bill has passed the Parliament. However, many tasks still lie ahead. As this chair mentioned at the last Board meeting for Pakistan, I again stress the importance of steadily implementing the program and of appealing the authorities' strong ownership both internally and externally. With this, further private capital inflow will be promoted and we can then expect improvement in external vulnerability. In addition, with a view to strengthening the fiscal balance and to realizing a more efficient economy, observance of the EFF/ESAF program is quite important. In this sense, it is most regrettable that the Performance Criteria regarding the Petroleum Development Surcharge was not observed in spite of its importance in strengthening the weak fiscal balance. I strongly hope that a new pricing mechanism will be introduced in the near future so that the authorities can secure a certain amount of revenue from this tax, and that the authorities will maintain the new system. Now, let me comment on some issues.

On fiscal policy, although the top priority is to achieve the fiscal deficit target, the authorities should achieve this target not by reducing expenditures, but by strengthening revenues. In this regard, it is a serious concern that the revenue projection has been lowered in spite of implementing contingency measures. Therefore, I share the staff's view that resolute action will be needed to strengthen the tax administration and broaden the tax base beyond that already envisaged under the program in order to raise revenue by 1.1 percent of

GDP. With respect to broadening the GST base to the service sector and to the introduction of the Provincial land-based tax, I hope these measures will be implemented without delay.

On monetary and exchange rate policy, I welcome that the authorities have moved on to a floating exchange rate system that is based on an interbank rate. I hope that the authorities will carefully manage the FCD conversion in order to minimize pressure in the exchange rate market.

On structural reform, strengthening the fiscal balance and promoting economic efficiency should be the authorities' main objectives. In light of these objectives, strengthening the financial conditions of WAPDA and the privatization of large public enterprises are quite important. I welcome that the tariff structure was rationalized and that preparations for privatization have proceeded steadily. However, on restructuring of WAPDA, we need to watch over future performance, as to whether the financial conditions of WAPDA will recover as projected, because there are some uncertainties in its relations with the IPPs and in its bill collections. On privatization, I hope that the authorities will proceed on this issue without further delay, as it had been delayed before the imposition of economic sanctions.

On the external front, although it is encouraging that the capital account has calmed down and the current account deficit is decreasing, their external vulnerability has not been eliminated. In order to fill the financing gap, the authorities need to face rescheduling negotiations sincerely. In this regard, I hope that the authorities will seriously tackle the restructuring of Eurobond as required in the Paris Club agreement.

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

Mr. Lehmussaari made the following statement:

I would like to congratulate the Pakistani authorities for their consistent implementation of economic policies, which has enabled them to meet all quantitative performance criteria for end-December 1998, and all but one structural performance criteria under the EFF program. The range of measures that Pakistan has recently implemented to address existing weaknesses in the economy shows the authorities' ability to pursue sound policies, and I hope that we will see the same, or even stronger, commitment throughout the remainder of the program.

Despite the encouraging developments that have helped to strengthen market confidence and improve the relations with creditors, the economic situation remains challenging. The biggest challenges appear to be in the areas of tax revenue collection, containing wage demands and resolving the issue of foreign currency deposits.

I broadly share the staff's assessment and policy recommendations. Let me therefore add remarks in only a few areas.

First, the key to macroeconomic stabilization lies in strengthening the government's fiscal position. While the authorities managed to keep the budget deficit within the target range for the first half of 1998/99, this was mainly achieved through one-time receipts and temporary containment of expenditures below program target level. Furthermore, revenues remained poor and tax collection was much weaker than envisaged. It is reassuring to see that there are a wide range of planned measures to improve revenue mobilization in the next fiscal year. I urge the authorities to take all measures to broaden the GST base and to strengthen of the tax administration.

In light of the poor budget revenues, the authorities have been right to contain current expenditures to secure the overall deficit level. Nevertheless, I am surprised to note that, in the current tight fiscal situation, the government has decided to provide a 15 percent pay increase for the armed forces much more than the increase in consumer prices, Moreover, the defense expenditures, which already formed around 21 percent of the total expenditures during last fiscal year, appears to be increasing even further this year [22 percent] and in the course of 1999/2000 [23 percent]. At the same time, social sector expenditures form roughly 10 percent of total expenditures. This is clearly a regrettable trend.

Second, I am glad to notice that one of the concerns that we had during the last discussion in January, namely the level of foreign reserves, has been addressed. The authorities have been able to replenish the foreign exchange reserves on a more comfortable level of around US$1.8 billion. More importantly, the decision to abolish the surrender requirement for foreign exchange earnings is welcomed and a right step to start to build up a well functioning foreign exchange market.

I also welcome the authorities' continued determination towards a market-determined unified exchange rate system. I am also glad to see that the authorities have used the Fund's technical assistance in fine-tuning the framework that would lead to a floating exchange rate. The staff rightly points to the need of enhancing the effectiveness of the transmission mechanism for interest rate policy as soon as possible, as interest rates will play a more important role in conducting monetary policy in the floating exchange rate regime.

Finally, Mr. Chairman, I urge the authorities to take quick actions in resolving the issue of foreign currency deposits. Establishing a timetable for implementing the exit strategy to the FCD problem is essential, and I welcome the information provided by the staff in the beginning of this meeting that conversions of FCDs have accelerated during the recent days.

Mr. Yakusha made the following statement:

I am encouraged by the favorable macroeconomic indicators for Pakistan, which seem to indicate that the economy and the overall situation are stabilizing. The accumulation of reserves is particularly commendable. I also welcome the recent initiative to restructure some US$510 million in commercial bank debt. We have the impression from the staff report that the authorities are doing their best to implement the program. Their efforts deserve support. I agree with the assessment that more structural measures may be needed to make the current reform efforts sustainable.

There has been a significant shortfall in both income tax and customs duties, which the staff primarily explains by pointing to lower inflation and more favorable exchange rate developments. I wonder, however, if the shortfall may not also be the result of a nonpayment problem or insufficient collection efforts? It would be interesting if the staff could disentangle the exogenous causes of the revenue shortfall from the more structural issues. I understand that there are no numbers available at this time on income tax compliance, and would welcome more information on the effectiveness of tax collection by the time of the next review. I would also be interested in the numbers on the compliance with the general sales tax (GST). We are concerned about the way that Pakistan covers the shortfall. For example, the early transfer of dividends raises concerns, as it postpones the shortfall to a later point in time. Moreover, profits from the central bank should not be relied on to cover structural budgetary problems. There is a room for further cuts in discretionary expenditure to cover the shortfall, but care should be taken not to cut productive investments. In that regard, I am concerned that the tightness in the budget is having a negative impact on the social action program and its 27 sub-programs. If growth were to be lower than expected, the budget would be even tighter. In that light, I am not sure that I share the authorities' optimism regarding the forecast for private sector growth in 1999, as the consensus forecast was a mere 1.1 percent of GDP, significantly below the authorities' projections.

Related to the fiscal vulnerabilities is the situation with the Water and Power Development Authority (WAPDA), where restructuring has again been delayed. The tariff increase which, if I recall correctly, was a prior action for this program in December was revised downward in March. We have no problem with the rationalization that put households and agriculture into high tariff brackets. However, the manner in which that rationalization came about was unexpected and caused a delay in the review for more than a month. Given the fragile confidence level in the investment community, I would hope that WAPDA starts operating more transparently and predictably, and that it stops relying on court decisions to conduct regular business. We are also disappointed that the program with independent power producers (IPPs) continues to drag on, as it could also have a detrimental effect on investor confidence. Could the World Bank staff comment on the status of the investigation of corruption in the awarding of contracts to IPPs?

The fixed tax schemes and trade enrollment schemes that have been introduced risk not capturing all of the taxpayers in the tax net, and they also do not necessarily represent a good governance practice. I strongly urge the authorities to abolish these schemes as soon as possible, not least because they violate the structural benchmark.

Regarding Pakistan's efforts to restructure its bonds, as Mr. Mirakhor indicated, Pakistan is having trouble identifying creditors. We are somewhat surprised by this hiding behavior, which could allow other bondholders to decide the restructuring terms. However, it may also be related to the fact that a formal meeting of bondholders has not been called. Pakistan should first focus on developing a menu of options for restructuring and then call a meeting. The longer the restructuring takes, the more nervous bondholders and other investors may become.

With these comments, we support the completion of the review.

Ms. Turner-Huggins made the following statement:

Like others we welcome this discussion, albeit another difficult one.

The staff has done a fine job in bringing this review to the Board and we appreciate their waiting until more concrete action was made before initiating today's discussion. I thank them also for all of their help during recent bilateral discussions. These are certainly not the best of times for Pakistan as it continues to be plagued by negative press and other reports highlighting nuclear weapon proliferation, widespread corruption and issues surrounding the eurobonds as mentioned by Mr. Sivaraman.

Without restating all of the concerns we had in January, our position remains skeptical despite the many hurdles overcome so far in meeting performance criteria and completing several of the structural benchmarks way ahead of schedule. For the latter commend the authorities and thank Mr. Mirakhor for his statement indicating that the authorities recognize that much remains to be done. In particular we welcome their commitment to focus on the long term structural issues including the emphasis on revenue generation by broadening the tax base and improvements to the financial status of the public enterprise sector, including WAPDA and the KESC. Further, we welcome his remark about the government's commitment to the social action program. Pakistan still heads the list in the region with some of the worst social indicators and we consider poverty reduction to be one of the key benefits of a successful ESAF-supported program. So this is an important commitment.

First, in the fiscal area, we have two main concerns. We share the concerns expressed by the staff and other Directors that without meaningful expansion of the tax base, Pakistan will fail to meet its fiscal objectives in the coming year or over the medium term. We are encouraged by the policy commitments being fulfilled in this area , especially that agreement has been reached with the chief ministers to adopt by end-June a uniform provincial land based tax. We endorse the staff's recommendations calling for elimination of the ad-hoc exemptions and fixed tax schemes (especially as applied to the manufacturing and retail trade sectors). We also urge the authorities to speed up the registration of taxpayers and continue to beef up tax administration. In light of the seriousness of the revenue issues in Pakistan, we wonder if the staff has given any thought to making revenue targets of the CBR a specific performance criterion? We would certainly support this for the next review. My authorities are concerned about the high level of defense spending and have embassy reports from Islamabad that the government may be contemplating a real increase of 3 percent in these outlays in the upcoming budget. We note however, that in the staff's program for 99/00--defense spending is expected to decline in real terms. We could not support a program which included any real increase in the defense budget next year and urge the authorities to limit these outlays to the fullest extent possible. As a bilateral donor Canada would find it difficult to continue its support of poverty programs when such large sums of government revenue go towards military spending.

In the external area, our main concern is that the staff may have exaggerated the return of investor confidence. While we welcome the helpful charts on page 6 which clearly show an optimistic view of external developments, these indicators may not paint the whole picture. In light of several factors including the ongoing disputes in the energy sector with IPPs, the steep falloff in private capital inflows in 98/99 (the lowest level since FY 93/94 and well below the peak of US$1.8 billion in FY 94/95), as well as controls imposed on foreign currency deposits, we are not so sure if the sanguine picture is warranted. I would welcome some comments from the staff as to how they see private capital inflows involving over the medium term and whether we can expect to see a rebound to the earlier levels. Having referenced the IPPs, I would appreciate hearing from the World Bank staff as to the status of the IPP resolutions, as we received last week news of another company in dispute , Seawind--suggesting that these problems remain active.

Finally Mr. Chairman, this chair would like to see more attention given to governance issues in the remainder of the program. I wonder if any consideration has been given to the establishment of an anti-corruption authority? This body, if credibly constituted (i.e with civil society and government) could go a long way in helping Pakistan regain some of its lost credibility in recent years by seeking to improve accountability throughout the society.

Last but not least, our chair can support the proposed decision and look forward to Pakistan's continued improvement under the ESAF-supported program.

The staff representative from the Middle Eastern Department acknowledged that the fiscal deficit target for 1999-2000 was ambitious. Given the low level of expenditures as a percent of GDP, especially social expenditures, there was not much room left to cut social or development expenditures, which actually should have been increased. Reaching the fiscal target would require an increase in revenue collection amounting to 1.1 percent of GDP. Since 1992-93, Pakistan's tax-to-GDP ratio had been about 13 percent of GDP. The staff intended to have further discussions with the authorities on how to reach the deficit target and would stress that it could not be at the expense of cutting social expenditures. The magnitude of the deficit was not as important as how the deficit reduction would be achieved and what structural reform measures would be implemented in the revenue area over the medium term.

The staff had proposed specific taxes with regard to petroleum taxation to make the budget less vulnerable to fluctuations in international oil prices, the staff representative explained. The government set the price of domestic prices of petroleum products based on international prices, taking into account intermediate costs, such as refinery costs. The difference between domestic retail prices and ex-refinery costs constituted budgetary revenue. The decline in petroleum prices in the past year had benefited the budget tremendously, which was why much of the shortfall in government revenues was compensated by revenues collected from the petroleum surcharges. Thus, revenue was more or less stable. However, that mechanism also implied windfall losses when there was a reversal in international petroleum prices. To stabilize revenue from petroleum taxation, the authorities had decided to commit to a fixed tax of a certain number of Pakistani rupees per liter. There would be a periodic adjustment to the domestic prices of petroleum, reflecting both developments in the international dollar price of petroleum goods and developments in the exchange rate.

The staff had not yet seen the draft 1999/2000 budget, which was currently being formulated, the staff representative said. The staff would soon return to Pakistan and hold discussions on that budget before its planned presentation to the parliament on June 12, 1999.

The latest information on agricultural taxation was presented in the supplement to the staff report, the staff representative noted. The World Bank staff was working with the authorities on the tax rate and the threshold.

It was difficult to say to what extent tax collection problems were related to compliance problems or exogenous factors, the staff representative commented. However, a number of factors in 1999 had affected revenue collection by the Central Board of Revenue (CBR). Changes in the advanced tax rules for corporate taxation had had some impact. The collections under the withholding tax on government securities had also gone down, as the treasury bill holdings by banks had declined. Customs revenues to the budget had been affected by a number of factors, such as compressed import volumes, especially in the early part of the year, and the decline in the effective rate of customs duties. However, the acceleration in rebates to exporters was nevertheless a welcome improvement.

Excise duties had been affected by the reduction in the excise tax rate on sugar in March, 1998, and the removal of excise duties on some other items, the staff representative continued. However, in some cases, the reductions in excise taxes was compensated through increased sales tax on those goods. The most encouraging area was the performance of the sales tax in terms of the revenue collected. In addition to the information provided in the staff report, the staff had recently been informed that 15,000 additional enterprises had been included in the GST net, bringing the total number covered to more than 54,000 enterprises. However, a number of large retailers and textile traders remained outside of that tax net. The staff's efforts and the program's focus to date had been in the area of the GST, but now the focus was moving to income taxation. A recent technical assistance mission related to income taxation had made recommendations to strengthen compliance and increase transparency in the income tax area.

There was no anticorruption authority per se, only a bureau that acted as an anticorruption unit, the staff representative reported. There was no information vis-à-vis plans to establish an anti-corruption authority in Pakistan.

The average effective tariff rate during 1998 was about 17 percent, and the figure declined to about 16 percent for the first half of 1999, the staff representative noted. That figure represented the ratio of tax revenue to total imports. If only dutiable imports were considered, that ratio was higher in the first part of 1999, at about 22 percent. In 1998, about 20 percent of imports were taxed at the 45 percent duty rate and 1 percent of imports were at the 40 percent duty rate. The reduction in the maximum tariff rate from 45 to 35 percent duty was expected to reduce the effective average tariff rate by about 2 percentage points.

Measures were being implemented to address the issue of nonperforming loans, the staff representative remarked. With regard to the flow problem, plans to strengthen supervision and prudential regulations were being implemented. Loans were also being more closely monitored, the latest regulations by the central bank were being applied, and the banks were being managed better. To strengthen loan recoveries, banking courts were being strengthened and bank cases in courts were being processed more quickly. Targeted schemes were also being implemented, with market based interest rates being charged by commercial banks. Under the two lending schemes put in place at the beginning of the fiscal year as mentioned in the staff report, only PRs 2.3 billion had been disbursed under those loans. The authorities had also set limits to reduce the stock of nonperforming loans. Those stocks were being reduced ahead of schedule and the cases pending in the courts were being addressed more rapidly.

The authorities' objective had been to accelerate the conversion of foreign currency deposit (FCD) until the unification of the exchange rate, the staff representative reported. To that end, the authorities had tried to put in place a market-based mechanism and increased forward cover fee to reduce the incentive to hold foreign currency deposits. The authorities were also attempting to eliminate the use of foreign currency deposits as collateral to make them less attractive. Since the unification of the exchange rate, the holders of foreign currency deposits could either convert their deposits to Pakistani rupees at the interbank rate or buy foreign currency in the form of foreign currency deposit bonds, with maturities of three to seven years that essentially tied up those funds.

With the unification of the exchange rate, the authorities had implemented other measures, such as the reduction of the reserve and liquidity requirements in order to ease the liquidity constraints of the banks and to safeguard their cash position, as such constraints could potentially threaten an orderly transition to a unified, market-determined exchange rate. The authorities considered those measures as temporary. The authorities had implemented similar measures when there had been major withdrawals from foreign currency deposit accounts in June 1998. In the fall, they had tightened monetary policy and increased interest rates. The staff had discussed that matter with the authorities, who were ready to increase interest rates if significant pressures emerged.

The performance criterion on CBR revenue was not a standard practice in Fund programs, partly because it was believed that the revenue outturn was not totally under the control of the authorities, the staff representative explained. However, there were programs that had performance criteria on revenue, including those for the Kyrgyz Republic and Ukraine, so that practice was not unprecedented. Pakistan's CBR revenues had clearly fallen short of initial program targets, and in the past those had been compensated by higher revenues from surcharges. Thus, there was an incentive to have less optimistic projections with regard to revenues. As a transition, the staff had imposed an indicative target on CBR revenues in the current program.

There had been a sharp reduction in private capital inflows in 1999, as expected, the staff representative remarked. However, the preliminary balance of payments data for the third quarter showed that private capital flows were much higher than projected in the program. That could reflect a reversal of the outflows that had taken place in the first half of 1999.

It was difficult to make reasonable projections for private capital inflows in the medium term, the staff representative continued. In 1994-95 and 1995-96, Pakistan had had a level of private capital inflows of about US$1.7 to 1.8 billion, although those reflected special circumstances related to investments in the energy sector. It was unlikely that in the next one or two years there would be capital inflows of more than US$1 billion per annum. Inflows would depend on the policies implemented by the authorities, the stability of the political situation, and governance issues, including the resolution of the IPP issues.

Regarding privatization receipts and their use, in the original Extended Arrangement program, it had been agreed that privatization proceeds would continue to be deposited in a special account at the central bank of Pakistan, the staff representative noted. It had been agreed that withdrawals from those accounts would be restricted to the retirement of public debt, although on an exceptional basis, after consultations with the staff, they could be used to cover costs associated with the restructuring of public enterprises. There had not been much movement in that account in the 18 months since the program had been approved.

The staff representative from the Policy Development and Review Department said that the restructuring of the eurobonds was not part of Fund conditionality, but was rather a matter of obtaining financing assurances for the program in a manner compatible both with the needs of the country and the need to involve the private sector. In the case of Pakistan, the Paris Club had decided to extend its comparability of treatment to eurobonds. The staff had supported that decision, because Pakistan required a comprehensive financing package with large amounts of financing from official and multilateral creditors. The amounts due on the eurobonds were therefore important and their restructuring was crucial to ensure that the program was appropriately financed.

Mr. Milleron made the following statement:

> As I have the privilege of being the first so-called non-lead speaker, I would like to say that I listened to the discussion with great attention and I will convey to my authorities, and especially to the President of the Paris Club, what I have heard up to now on various issues related, in particular, to the difficult question of eurobonds.
>
> At this stage, I will ask four questions, and you will see that they are rather specific.
>
> First question, it is a good idea to try to implement the petroleum development surcharge. I do not understand why the proposed price adjustment formula will be implemented only at the beginning of October, if I read properly Paragraph 21 of the note. Why do we have to wait such a long time, especially considering the new outlook on the oil market?
>
> Second question, the financial situation of the water and power development authority is certainly something important, and apparently restructuring remains subject to regrettable delays. So, I would like to understand why we have these delays. Also, I would be interested in understanding whether the tariff increases effective last April will be sufficient for WAPDA's profitability. Where do we stand from that point of view? Are we still looking forward to new increases?

The third question is related to banking privatization. The date of complete divestment from the Muslim Commercial Bank and Allied Bank was supposed to be at the end of March. It seems that it has not been fully implemented. Could the staff elaborate a little bit more? I know that this point is mentioned in the so-called memorandum of economic and financial policies, in Paragraph 33. But, what are the reasons for the delay? It is something that is certainly an important benchmark of the program.

Fourth, and last question, on the question of tax collection; I understand that it is a crucial issue. I wonder what kind of incentive we could propose in order for tax administration to be perhaps a little more efficient, or are there some bilateral initiatives that could be envisaged? In other countries, there were some useful and interesting bilateral initiatives that were taken to help and to propose to share know-how. Is it something that was envisaged in the case of Pakistan? On this issue, maybe you would also like to comment more.

Mr. Pickford made the following statement:

I welcome this discussion. I believe that there has been some progress made by the Pakistani government, but much remains to be done in three areas: the country's fiscal position, its structural problems, and the need to rebuild investor confidence.

Some progress has been made since the Board's last discussion, in particular vis-à-vis the better than expected improvement in the external position and the unification of the exchange rate. However, there is considerable distance to go on the three areas mentioned earlier.

The fiscal position is the most worrying aspect. Fiscal targets appear to have been met in the short term by taking account of profit transfer from the central bank and by taking advantage of lower interest payments. Progress on raising revenue has been not as good as had been hoped. Therefore, I agree with the need to broaden the general sales tax and strengthen tax administration. Some of the actions that have been taken, for example the introduction of fixed tax schemes and the enrollment schemes mentioned in paragraph 19 of the staff report, have gone in the opposite direction. I wonder whether there is some scope to reverse that?

I am concerned that the authorities had indicated they would make further cuts in "lower priority spending" if additional fiscal measures were needed. Given Pakistan's situation, this runs the significant risk of cutting into social expenditures. Improving the situation in terms of basic social indicators would be regarded as a measure of success. We would be concerned if spending cuts were to jeopardize that, as it appears that the social action program is not fully financed at the moment. If there is a fiscal problem, therefore, progress should be made on the revenue side. As Ms. Turner-Huggins said, it is well worth considering making Central Board of Revenue revenues a performance criterion.

While there has been progress on the structural side, there should be further reforms in the power sector, the civil service, and public expenditure systems. Restructuring is proceeding rather slowly. I was concerned about a statement in paragraph 27 of the staff report that some of the cost savings identified in the financing plan are based on assumptions about the outcomes of court cases. Could the staff comment on that? There are some encouraging signs regarding the dispute with independent power producers (IPPs), but the staff should continue to monitor progress until a deal is concluded and implemented with the IPPs

On the issue of the eurobonds, I join with others in urging the government to make progress on reaching an agreement with creditors in order to avoid the possible risk that the Paris Club agreement would not be implemented.

Pakistan's performance to date warrants continued Fund support, and we are prepared to agree with the proposed decision. However, much remains to be done by the government. There must be consistent and full implementation of the policy measures, and the staff must continue to monitor the situation carefully to ensure that implementation takes place. I wish the government well.

Mr. Pascual made the following statement:

I would like to start by congratulating the staff for the comprehensive report and update of Pakistan's progress under the programs since our last review in January. In fact, the paper is detailed and provides us with all the necessary elements to reasonably understand all the difficulties and efforts the program entails.

In addition, I find the thrust of the paper and the recommendations included in it most appropriate, not only because of their economic rationality, but also because of the high degree of pragmatism they exude. This being said and given that the authorities' efforts are in line with program expectations and the program has been conveniently adjusted, I support the proposed decisions and the waiver requested.

Demand management policies must continue supporting the reform process. So far, both fiscal and monetary targets seem reasonable in reaching a balance between growth and external sustainability. Perhaps stronger efforts should be made on the fiscal side, but all in all they are consistent with the general purpose of the program.

However, structural reforms require more attention. As the detailed description of major measures has already been made, I will only emphasize on a few.

In the fiscal field, once again the general target is to achieve a level of revenue within a framework of a sufficient non-distortionary system which ensures enough resources for the public sector to play its role. In this light, the rapid implementation of the GST, the elimination of undue exemptions, the introduction of the CTI, and the implementation of a uniform provincial land-based tax on agricultural income are crucial measures to be carried out promptly. All unnecessary delays must be avoided, because beyond the good accomplishment of annual fiscal target, credibility is at stake.

In the monetary realm, many improvements have taken place, especially with regard to the implementation of new tools and techniques of conducting monetary policy and of intervention in the markets. However, I am concerned with the measures aimed at encouraging discriminatory credit to some specific sectors of activity with the help of subsidized refinancing schemes. This kind of measures could jeopardize the soundness of the financial system and they definitely do not help to the best allocation of resources in an economy in change.

On the restructuring and privatization of the public-owned enterprises, I encourage the authorities to keep on working hard in cleaning up most representative companies—in particular WAPDA and KESC. They are not only a burden for the public accounts, but also a symbol of lack of transparent management.

Last, but not least, on debt restructuring I must confess my surprise for the last news regarding the payment of coupons due on the Eurobond outstanding issues. I want to remind the authorities about the importance of the Paris Club's Agreement to ensure the financing of this program. Besides, the comparability of treatment upon which the agreement was founded is a cornerstone of the new strategy in the prevention and resolution of crisis explicitly supported by this Institution. I find it difficult how we could continue supporting Pakistan, while they do not fulfill fundamental agreements like the one of the Paris Club. However, this being said in defense of the coherence of action of international institutions, I must admit that I understand the Pakistani's objections to such a difficult, time-consuming and unprecedented debt restructuring. I hope they will find appropriate mechanisms to settle the issue. I encourage the staff to closely collaborate with the authorities to this end. This is not only in the benefit of Pakistan, but also of others as well. My best wishes to the authorities in these and future tasks.

Mr. Mirakhor said that Mr. Pascual's objection about the payment of coupons due on the outstanding eurobond issues was understandable. However, the authorities had consulted with the Paris Club, and both sides had reached an understanding regarding the payment on those coupons. Furthermore, the authorities had no objections regarding the coupon payment, but were simply trying to contact bondholders. Progress was now being made, although it was a new area and it was difficult to know how to proceed.

Mr. Pascual said that there was an agreement with the Paris Club on the matter of the coupon payment. At the end of 1998 it was unclear whether the agreement had been honored. The authorities should make every effort to honor the letter of the agreement as well as its spirit.

Some members of the Paris Club had not been pleased with the negotiations, Mr. Pascual continued. They felt that not all of the measures possible had been taken in talks with the bondholders. It was important to get an agreement, especially as the Fund was interested in involving the private sector.

Mr. Mirakhor said that there was no evidence that the authorities had violated the spirit of their agreement with the Paris Club. There was also no indication that any Paris Club member had been dissatisfied with Pakistan's progress to date. The authorities fully understood the importance to the Fund of the agreement with the Paris Club and would honor their commitments.

Ms. Ongley made the following statement:

At this stage of the discussion, more or less all of my points have been raised by other chairs or my questions answered by the staff. I would therefore like to make a couple of points for the record.

Fiscal adjustment and reform is the lynch pin of the program. Here, I would like to echo the comments made by Mr Kiekens & Mr Nemli, Mr Yakusha and Mr Pickford. Persistent revenue weaknesses are of concern. And, while the broadening of the GST base is promising, there are a number of areas where problems have been identified and responses foreshadowed, but action is yet to be taken. These pose the greatest risk to the ongoing fiscal position and therefore warrant urgent attention.

In view of the non-observance of the performance criteria relating to the petroleum development surcharge, the authorities proposed response and the movement to an automatic pricing formula seem appropriate.

Of more concern is the breach of the structural benchmark in relation to fixed tax and trade enrollment schemes. These schemes are far from optimal and have the potential to erode further the tax based. Action to eliminate these schemes should be taken at the first possible opportunity.

We remain open to the idea of land-based taxation provided this is the best way of accurately raising revenue on agricultural income in Pakistan. We look forward to seeing how the proposed reforms in this area perform.

The staff's supplement notes that a number of issues related to Independent Power Producers remain "unresolved" - these should be addressed as soon as possible.

Given the significance of WAPDA's restructuring for the fiscal position, we would stress the need for further action here.

Like the staff, we have reservations about the temporary extension of the subsidized refinance scheme for yarn exporters. The existence of subsidies, concessions and guarantees can result in a less than optimal credit allocation and weaken the loan portfolio of financial institutions. This can bring into question the integrity and credibility of the financial sector, the consequences of which we have seen in Asia.

In the area of bond restructuring, progress seems somewhat slow, particularly given the significance of bond restructuring for Pakistan's external financing position. a more speedy consideration of these issues would seem warranted.

On a final point about last Thursday's cyclone. We would like to extend our sympathies to the authorities at this difficult time. While it is probably still too early to assess fully its social and economic impact, I would be interested in the staff's early reactions about what implications this may have for the program. It would also be useful for the staff to informally update the Board on any possible adjustments to the outlook for Pakistan when this information is available.

In conclusion, we support the proposed decision and wish the authorities well in the months ahead.

Mr. Donecker made the following statement:

First a brief comment on a more technical issue: it is regrettable that the staff document gives no indication of the size of the disbursement that will be released under the EFF after concluding this third review. One has to check previous documents to hopefully arrive at the right figure. This practice has happened also in several other country cases in recent months. We therefore would urge the staff to be much more transparent on this important issue in this and all other country cases in future.

Pakistan's underlying program, Mr. Chairman, appears to be broadly on track. But like other speakers, I still have some doubts on whether the authorities are already fully committed to the right course for a sustainable economic development and for meeting the program targets in the medium term. As they are well aware of, the economic situation remains fragile and there continue to be substantial downside risks to the program.

Looking at the macroeconomic picture, we welcome certain positive signs and policy improvements, such as the unification of the exchange rate system. Inflation is on a downward trend based on a prudent monetary stance; but the risk of renewed inflationary pressures arising during the remainder of this year cannot be excluded yet. There has also been a substantial build up of foreign reserves. The process of fiscal and structural reforms is still lagging, however.

That does not mean that there has been no progress on the fiscal and structural front. But there were backslides in policy implementation. We therefore find it difficult to share the staff's optimism that significant progress has been made in those areas. In my following remarks I would like to demonstrate this with three examples.

First, on fiscal policy the budget deficit was kept on target during the first half of 1998/99; but this could only be achieved by offsetting tax revenue shortfalls through higher nontax revenues and containment of expenditures below program levels. Therefore, as the staff has rightly pointed out, substantial weaknesses in revenue mobilization persist. This strongly increases the risk of failing the deficit-target for the coming fiscal year 1999/2000. We therefore urge the authorities to take additional substantial measures in line with the staff's recommendations. These should include a broadening of the tax basis, a further reduction of tax exemptions, as has been partially done for the general sales tax, and improvements in the efficiency of tax administration. In this context, it is a welcome step that the first phase of a provincial land-based tax on agricultural income are to be implemented by end-June 1999. Developments in the expenditure area are also a point of concern, in particular, the recently announced pay increase for the armed forces of about 15 percent. This is even more regrettable as the country urgently needs an enhancement of public expenditures in other areas like basic social services.

Secondly, there are also progress and setbacks in the area of trade liberalization. The implementation of trade reform measures by end-March

1999 like the lowering of the maximum tariff rate is certainly welcome. On the other hand, the recently imposed regulatory import duties on edible oil, soybeans and sugar is regrettable.

Thirdly, the reform of the power sector has gained some momentum. However, the financial weaknesses of the Water and Power Development Authority (WAPDA) persist and its restructuring has been delayed; this poses also a serious risk for the public budget. Can the staff comment whether the tariff increases planned for end of March were actually fully implemented on time?

Summing up, there has been commendable progress in various areas as mentioned above, but also—at the same time—important policy slippages. Against this background and Pakistan's disappointing track record under former programs, we, too, urge the authorities to increase their efforts with regard to fiscal consolidation and budget restructuring—including reducing military expenditures—as well as the implementation of the agreed structural reforms.

Mr. Palei made the following statement:

It is clear from the Memorandum of Economic and Financial Policies, Mr. Mirakhor's statement, and the staff papers that the program remains on track. Although the economic situation is still fragile, there are positive signs on the inflation front, interest rates have declined, and the balance of payments has improved. The results of the program implementation by the Pakistani authorities bode well for the completion of the third review. As I share most of the points presented by the staff in their concise and well focused report, I will limit my statement to a few observations.

One of the most visible steps recently taken by the authorities is the unification of the official and interbank exchange rates. Given the relatively short period of macroeconomic stability, unification is a rather bold step that raises the stakes in the implementation of the program. To me, the earlier than envisaged unification of the exchange rates is a clear sign of the authorities' commitment to the program. It is obvious that maintenance of the established exchange regime from now on will be one of the key indicators of economic progress in Pakistan. The program with the Fund establishes specific rules for the reserves to be maintained above a certain level and limits the ability of the authorities to intervene in the exchange markets. In my opinion, the use of interest rates to influence the exchange rates also faces technical and economic constraints. It is imperative, therefore, that the authorities come up with a persuasive strategy to manage investors' expectations and to maintain the high degree of confidence in the Pakistani economy. Continuation of the program with the Fund and progress in fulfillment of Pakistan's obligations under the agreement with the Paris Club certainly are among the main pillars of such a strategy. Among the vital balance of payments problems for Pakistan is the potential withdrawal of Foreign Currency Deposits (FCD) in a higher than currently expected volume, and at a higher pace. In my view, the risks of a Rupee depreciation associated with FCD conversion and/or any other developments should be explicitly taken into account in the design of the program and, especially, in the contingency planning.

It has been repeatedly said that a permanent and weighty increase in fiscal revenues is absolutely essential for the success of the program in Pakistan. Hence, continuing shortfalls in revenue collection are disappointing. According to the staff, in 1998-1999, fiscal targets were met largely owing to the introduction of some contingency measures, to an earlier-than envisaged dividend payment from Pakistan Telecommunications Company Limited (PTCL) as well as by a profit transfer from the SBP. I certainly support the staff and other directors in their calls for the authorities to press ahead with the implementation of all of the measures aimed at the enhancement of revenue collection, including the revision of exemptions under the GST and of the exemptions under custom duties, and also including the introduction of the agricultural income tax, GST taxation of services, and broader coverage of businesses by taxpayer identification numbers.

While appreciating the difficult fiscal situation in Pakistan, I would like to raise the issue of the sources of tax collection, and, in particular, to elaborate on the balance between taxation of the energy sector and that of foreign trade. In my view, the high burden of taxation placed on the energy sector should be a matter of concern and should be revisited. If I am not mistaken, under the program, independent of the changes in international prices, the energy sector is supposed to deliver about twenty percent of revenues, similar to last year's performance. At the same time, the situation now is different, primarily owing to the significant recovery in world oil prices. I am afraid that the recent dramatic increase in world prices of petroleum products, combined with many measures already introduced by the authorities or waiting to be introduced soon, could lead to a severe supply shock to the Pakistani economy by sharply jacking up the domestic energy prices.

Allow me to mention some of the factors affecting domestic prices on energy. The unification of the exchange rates effectively eliminated an implicit subsidy on petroleum imports. Unification and an effective switch to floating, as argued above, could easily lead to a noticeable depreciation of the Rupee and to a corresponding increase in domestic energy prices. Furthermore, the authorities envisage the removal of the GST exemptions for electricity, gas, and petroleum products and an extension of GST to gas distribution. Finally, this review introduces a new mechanism of fixed surcharges on petroleum products and an automatic price adjustment mechanism which is likely to lead to a significant pass-through to consumers of the changes in international prices and exchange rates. To summarize my concerns, emphasis on heavy taxation of the energy sector represents, in my view, a risky strategy for fiscal consolidation. Increases in domestic prices on energy may hamper the growth prospects for the Pakistani economy and, on top of that, could become a socially explosive issue. Therefore, it is essential not only to speed up medium-term oriented structural changes in revenue collection, but also to shift the emphasis to other sources of revenue in the short run.

Customs duties are one of the primary candidates for a change in the structure of tax revenues in the short run. Already during the Board's January discussion this chair expressed concern about the rapid losses of tax revenues on international trade. In particular, I called for revenue neutrality of the foreign trade liberalization. At the beginning of this year, the oil prices were still low and there was room in Pakistan to exploit this favorable situation in the energy sector for tax purposes. The rebound in world oil prices makes a revision of taxation of foreign trade even more urgent. In the situation of continuing shortfalls in revenue collection, and at this critical stage of the program, it is not prudent to forsake revenues from foreign trade taxes based on shaky expectations of fast improvements in revenue collection. In fact, given the fragility of the situation, in addition to elimination of exemptions under custom duties, stressed by the staff, some temporary uniform increase in tariffs could be a necessary contingency action. In any case, continuous monitoring of foreign trade taxes is indispensable. In the staff papers I did not find any recent data on collection of foreign trade taxes. It would be useful if the staff could provide these numbers.

I wish the authorities success in the implementation of their ambitious program.

Ms. Lissakers made the following statement:

We recognize that there have been some positive steps in Pakistan taken by the authorities. Our concerns are similar to those expressed by others: firstly, that the program itself is not a strong enough response to Pakistan's situation; secondly, that while most of the targets in the program have been met, particularly in the fiscal area, they do not appear to have been met in a way that is sustainable. I would associate myself with the remarks Mr. Kiekens made in his statement and those of others.

On the balance of spending between military and social, I agree with the comments made by our Canadian colleague and others that, given the acute social needs, it is doubly unwise for Pakistan to be devoting as much of its limited fiscal resources as it is to the military side.

On the power side, this is obviously a large part of the public sector's financing problems. There has been some progress, but the continued accumulation of GOP arrears to WAPDA, I think, should not be dismissed lightly. These arrears have served in the past as an accounting maneuver to allow the GOP to meet its budget targets, but these kinds of transactions threaten WAPDA's financial integrity, the achievement of a real solution to the IPP problem, and the overall stability of Pakistan's finances.

On the IPPs, again, while there is, at least on paper, an orderly framework, the real and continuing problems are having a severe impact on the investment climate. I wonder whether the staff is not a bit sanguine regarding the prospects that if these disputes go to international arbitration, the GOP is likely to lose at least some of these cases, which could again throw off the whole financing picture for WAPDA and for the public sector generally.

On the bonds, I join others who stressed the importance of finalization of negotiations between the government of Pakistan and its bond holders. I am glad to hear Mr. Mirakhor say that the authorities are firmly committed to making this happen.

Two points on the governance and labor issues. On governance, I have to say that, while it is certainly not part of the Fund program, my authorities are disturbed by the arrest of the Pakistani journalist two weeks ago – a journalist who appeared to be focussing public attention on the issue of corruption; so it is not totally outside our realms of concern. I would just say generally that Pakistan at this point has no reservoir of goodwill or credibility on this issue with the international community, and this kind of development can only further weaken the international support for Pakistan.

I had raised concerns about the labor market situation, and child labor in particular, in Pakistan last time. I will not repeat those concerns, although they remain a matter of high importance to us. I will share with Mr. Mirakhor and with the staff some specific concerns that my authorities have in that regard.

Mr. Zurbrügg made the following statement:

At the time of the last discussion on Pakistan, our chair did not support the Fund program. In our view, the program was characterized by various shortcomings and uncertainties. While I continue to have doubts on the strength of the program, I was positively surprised by the relatively good macroeconomic performance over the last months. I welcome the fact that all financial performance criteria were fulfilled. Furthermore, the earlier than anticipated move to a market-determined unified exchange rate system is commendable.

This being said, the main weaknesses of the program remain untackled and continue to pose a significant risk. First, and foremost, progress in the fiscal area remains disappointing. In particular, tax reforms have been delayed and tax revenue has fallen short of program targets. According to the staff, this shortfall will be offset mainly by further expenditure cuts. While there certainly is scope for further expenditure cuts, I urge the authorities to avoid any cuts in the social sectors. In this context, I am also concerned regarding the large and increasing share of military expenditures. The poor record in generating tax revenues is one of the main problems of the Pakistani economy and should be addressed forcefully. This would mean strengthening tax administration, broadening the tax base (including in the agriculture sector) and further reducing the scope of tax exemptions. Clearly, the fiscal performance criteria for end-March were achieved only thanks to one-off measures. This policy is unsustainable and only makes it more difficult to achieve the further program targets.

Second, progress in the structural area remains insufficient. Particularly, the financial performance of WAPDA is still a serious risk to the program. I urge the authorities to implement the restructuring of this institution as well as other public enterprises as rapidly as possible in order to reduce this large burden for the budget. I am also worried about the effective implementation of other key structural reforms, including those in the fiscal area. I am alarmed that, according to the staff, the implementation of these important reforms could be "jeopardized".

Finally, I am disappointed by the lack of progress on bond restructuring. While recognizing the difficulties of such an endeavor, non-compliance with the Paris Club condition regarding the comparability of treatment clause for private bondholders would undermine the financing of the program and cast doubt on the crucial issue of private sector involvement in crisis resolution. I urge the authorities to move rapidly in order to have an agreement in place by the end of the year.

The staff representative from the Middle Eastern Department said that the staff had had extensive discussions with the authorities on the petroleum price adjustment formula in April 1999. In order for the authorities to implement price adjustments a formula had to be agreed to. The staff would pursue that issue with the authorities in its upcoming mission, in order to decide on what mechanism to use and what international price index to follow for the adjustments of domestic prices. The staff had discussed the possibility of having even more frequent adjustments than quarterly adjustments, although the authorities felt that quarterly adjustments would be more feasible. As the formula was expected to be decided during the staff's upcoming mission, it would take effect at end-June 1999. The authorities had wanted to carry out the first adjustment after three months, which was why the October date had been set.

The taxation of petroleum was quite high, the staff representative confirmed. The exchange rate adjustment had affected petroleum prices substantially. Part of the reason why the taxation of petroleum was so high was that when the Central Board of Revenue's revenue targets were not achieved, the authorities had compensated for the shortfall by imposing higher petroleum surcharges. In the 1999 budget, energy surcharges accounted for about 19 percent of the total tax revenue.

The staff did not have any more recent information on the privatization of the Muslim Commercial Bank, the staff representative reported. The matter was still being looked at and offers from prospective buyers were being considered.

The staff did not have full information on the impact of the cyclone and had not discussed the matter with the authorities, the staff representative said. The staff would be able to assess the situation during its mission the following week.

Regarding the Water and Power Development Authority, the tariff increase envisaged for end-March had been implemented, the staff representative noted.

It was difficult to say what kind of incentives could be put in place to improve tax collection, the staff representative remarked. Tax reform measures in Pakistan had so far focused on the GST and in the future would focus on income taxation in order to increase accountability, reduce exemptions, and increase enforcement so that tax collections were more in line with expectations.

Regarding Mr. Donecker's question about the size of the disbursement that would be released under the Extended Arrangement (EFF) after concluding the third review, that figure was inadvertently omitted from the staff report, the staff representative explained. That figure was SDR 37.91 million.

Regarding the issue of why the tax-to-GDP ratio did not appear to be increasing, the decline in customs duties had had an impact on the overall tax performance of the economy, the staff representative observed. In 1992-93, customs duties had accounted for 4.7 percent of GDP, while under the current program they were expected to amount to about 2 percent of GDP.

The staff representative from the Policy Development and Review Department said the fact that the staff report, and perhaps others, had not included information on purchase amounts was an oversight and did not reflect any intention by the staff not to be transparent. The staff would attempt to make sure that such figures were not omitted in the future.

The staff representative from the World Bank said that the Bank staff had received assurances that the anticorruption office would no longer be involved in commercial matters involving the independent power producers (IPPs). The Water and Power Development Authority (WAPDA) had been given the sole responsibility by the government to work out the remaining commercial and technical IPP issues. A number of IPP companies had suggested that the climate of discussions had improved considerably, and most technical issues, such as fuel supply and interconnection with the WAPDA grid, appeared to have been resolved. Although many other IPP matters remained unresolved, the orderly framework was by and large being implemented. However, the progress on reaching outcomes satisfactory to all of the parties had been slower than the staff had expected in January 1999. The staff had urged the government to resolve the remaining IPP issues expeditiously, as they adversely affected the investment climate. Nevertheless, there was still a risk that an agreement over prices and contractual disagreements might not be reached with some IPPs, which could impose financial claims on the government that had so far been avoided. The last standstill agreement to halt legal proceedings by IPPs against the government, and vice versa, was expected to be concluded that week.

WAPDA had been placed under a military administration to eliminate corruption, improve billing and collection, and change its bureaucratic culture, the staff representative reported. About 35,000 soldiers were currently engaged in eliminating electricity theft and regularizing billing and collection. The army involvement was expected to last about six months, although senior army officers would remain in charge of WAPDA companies to ensure that the benchmarks established by the army continued to be met. The theft reduction campaign appeared to be producing results, some of which were unintended. Electricity demand in the first four months of 1999 had fallen about 6 percent compared to the same period in 1998. However, the collection of revenues appeared to have increased by 25 to 30 percent, which was being confirmed by a mission currently in the field. A number of prominent individuals had also been named as electricity thieves.

The restructuring of WAPDA was proceeding more slowly than had been hoped, the staff representative continued. There was a good deal still to be done, such as installing key personnel and working out a number of technical arrangements, including the contractual arrangements among the new companies and their opening balance sheets.

Some of the press reports about reductions in tariffs did not appear to be correct, the staff representative reported. The staff had estimated that the average tariff would rise by 9.4 percent following the recent tariff increases. The finances of WAPDA continued to be a concern, and the staff was currently reviewing WAPDA's financial projections. In addition to increases in tariffs, there were a number of important factors regarding the finances of the power sector, including the domestic price of fuel, how to sustain the results of the theft reduction program, the future development of the electricity market, particularly sales of electricity, and the collection of arrears. The collection of arrears from the federal government appeared to be proceeding well, although there were still concerns about collections from provincial governments. There was scope for cost reduction and the disposal of excess assets.

There also appeared to be a need for a thorough financial restructuring of the power sector. There were commercial discussions between WAPDA and the IPPs, the results of which would have a large bearing on WAPDA's finances.

Mr. Mirakhor made the following concluding statement:

> The staff has answered all questions comprehensively. They have left little for me to cover, and, as time is somewhat short for the next two items, I shall only address one of the issues raised by Ms. Turner-Huggins, i.e., the question regarding an anti-corruption authority. For a long time, Pakistan has had a similar structure in form of a commission called the "Ihtisab," headed by a judge. I have looked into the mandates of some of the anti-corruption authorities observed in other countries, and the mandate of Pakistan's Ihtisab, or the accountability commission, seems to be similar to those of anti-corruption authorities established elsewhere. The major difference is, I believe, the involvement of civil society representatives on this commission. This is a different organization from the Ihtisab Bureau that was referred to by the World Bank representative. The latter was established by the Interim government to investigate corruption of the previous government's tenure. It has been active, and, basically, it is this same organization that has begun the IPP investigations because of some irregularities found in contracting operations between the previous government and some of the IPPs. I do not know whether the government would want to expand the present accountability commission to include representatives from the civil society, but it is an important issue that I will transmit to the government.
>
> One general comment: Mr. Santos suggested that, while there has been some progress, Pakistan is still far from being a success story. I think, this depends on the benchmark you use. If you use Pakistan as benchmark, especially its performance in the last few years, the fact that we are here for the third review is a major success. Some of the sundry issues have unfortunately clouded the achieved progress. The staff has referred to many progress areas. The progress I am pleased with is the one made in the financial sector and banking reform. Questions of governance have been dealt with in this sector, and I think that we are beginning to see an efficient financial and banking system. The evidence is the reduction of intermediation costs in the banking system. One of the major indices of success of reform is that the rate of infection of system portfolios has declined markedly.
>
> I will pass on the message of this Board as I have understood it. In sum, the Board's view is that the government needs to continue taking measures and to expand efforts in the area of sustainability of stabilization and to strengthen public finances—especially on the revenue side; also governance issues will have to be addressed. The government should take measures to re-invigorate

growth, deepen structural reform, and do its utmost on the external sector viability, including, the settlement of the bond restructuring issue.

I thank the Directors for their interest and support, and thank the staff for their efforts.

The Executive Board took the following decision:

1. Pakistan has consulted with the Fund in accordance with paragraph 3 of the Extended Arrangement (EBS/97/185, Sup. 2), and paragraph 35 of the Memorandum on Economic Policies attached to the letter dated September 8, 1997 from the Minister of Finance and Economic Affairs and the Governor of the State Bank of Pakistan in order to reach understandings regarding the circumstances in which purchases under the Extended Arrangement can be resumed.

2. The letter from the Minister of Finance and Economic Affairs and the Governor of the State Bank of Pakistan dated May 3, 1999, with the attached Memorandum on Economic Policies and Tables, shall be attached to the Extended Arrangement, and the letters dated September 8, 1997, February 22, 1998, and December 21, 1998 with their respective attached memoranda and tables shall be read as supplemented and modified by the letter dated May 3, 1999 with its attached memorandum and tables.

3. Accordingly,

(a) the quantitative performance criteria specified in paragraph 3(a)(ii) of the Extended Arrangement shall be as specified in Table 1 of the memorandum attached to the letter of May 3, 1999.

(b) Paragraph 3(aa)(ii) concerning the petroleum development surcharge rate shall be deleted and paragraph 3(aa)(iii) shall be renumbered as paragraph 3(aa)(ii).

(c) Paragraph 3(b)(ii)(1) concerning the extension of the General Sales Tax (GST) to services shall be deleted and paragraphs 3(b)(ii)(2) and 3(b)(ii)(3) shall be renumbered as paragraphs 3(b)(ii)(1) and 3(b)(ii)(2), respectively.

(d) The following paragraph 3(b)(iv) shall be added after paragraph 3(b)(iii) of the Extended Arrangement:

"(iv) by July 1, 1999,

(1) the extension of GST to the services specified in paragraph 21 of the memorandum attached to the letter of May 3, 1999, or

(2) the introduction of fixed surcharges and an automatic price adjustment formula on petroleum products specified in paragraph 22 of the memorandum attached to the letter of May 3, 1999, or"

(e) paragraph 3(b)(iv)(2) shall be renumbered as paragraph 3(b)(v)(2) and paragraph 3(b)(iv)(1) concerning the removal of the GST exemptions for petroleum products and electricity shall be deleted and replaced with the following new paragraph 3(b)(iv)(1):

"(i) the removal of the GST exemptions for petroleum products, electricity, gas and gas distribution as specified in paragraph 21 of the memorandum attached to the letter of May 3, 1999, and Table 2 thereto, or"

4. The Fund determines that the third review specified in paragraph 3(c) of the Extended Arrangement for Pakistan has been completed, and that no further understandings are needed for Pakistan to resume purchases under the Extended Arrangement. (EBS/99/72, 5/21/99)

Decision No. 11964-(99/55), adopted
May 24, 1999

3. REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director, Mr. Sugisaki, reported on his recent travel to Portugal—Macau, and the People's Republic of China.

4. FUND'S LIQUIDITY AND FINANCING NEEDS—REVIEW

The Executive Directors considered a staff paper on the review of the Fund's liquidity position and financing needs (EBS/99/49, 3/29/99; and Sup.1, 5/19/99).

Mr. Shaalan and Mrs. Farid submitted the following statement:

After deteriorating to historically low levels in 1998, the Fund's liquidity position has improved significantly with the coming into effect of the quota increase. The Fund's usable resources have been augmented by SDR 46 billion and the liquidity ratio is forecast to be slightly above 100 at end-2000. This is based on the assumption that the global economic situation will continue to improve, allowing an easing of demand for Fund resources from the exceptionally high 1998 levels. For the period immediately ahead, we find the staff assumptions reasonable in view of the projected sizable repurchases projected over the next two years. These repurchases could be expected to accommodate the projected strong demand for Fund resources until end-2000 without impairing liquidity.

The staff paper shows clearly, however, that we have entered a new era in the provision of Fund resources to members in view of the increasing size and volatility of global capital flows, and the consequent increase in the size of Fund arrangements and the shorter repayment periods associated with SRF programs. The resultant volatility in the Fund's liquidity ratio could translate, over the medium term, into a perception of a weakened ability of the Fund to help its membership. While this question lies outside the scope of today's paper, we nevertheless should begin thinking seriously about this eventuality, particularly with the coming into effect of the Contingent Credit Line (CCL). It may well be true that the CCL will reduce the use of Fund resources. Indeed, we hope it will. However, the opposite may also be true. We, therefore, would appreciate staff's elaboration of the last sentence in paragraph 18, namely that, "greater use of such a facility would result in greater volatility in the liquidity position in future and this would need to be taken into account in judging the adequacy of the Fund's resources over the medium term." Specifically, how do they expect to take this increased volatility into account?

Turning to the issue of how to treat precautionary arrangements and CCLs, we agree with the change in approach proposed by staff in accounting for these commitments in the assessment of liquidity. This is justified by the growth in the number and amount of commitments under precautionary arrangements in recent years, and the likely expected increase in demand as more members include CCLs in their crisis prevention strategies. We, therefore, can agree that when calculating the Fund's uncommitted resources, the full amount of resources committed under precautionary arrangements and CCLs should be taken into account. At the same time, given the contingent nature of these arrangements, it would also be appropriate to assume that no purchases would be made under such arrangements over the projected period. This provides a straightforward and transparent indicator of the Fund's uncommitted usable resources, while at the same time taking into account the contingent nature of CCL commitments. The resultant impact of such arrangements on the Fund's projected liquidity would therefore be about half the impact of ordinary stand-by or extended arrangements. In our view, such an approach is far more appropriate for the Fund than an arbitrary probability-weighted approach, which would offer little guidance for the Fund's liquidity management.

Mr. Schlitzer made the following statement:

This is an important discussion, in view of the major changes that are being proposed by the staff to the framework that has traditionally been used to determine the Fund's liquidity position. I am therefore glad that it has been brought to the Board, allowing for an exchange of views that can be reciprocally fruitful. I am also grateful to the staff for offering us a clear exposition of such a complex matter. I will comment first on the liquidity review and afterwards on the proposed modifications to the current framework.

Evaluation of liquidity position

With the quota increase and the enhanced borrowing capacity of the Fund under the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB), the Fund's liquidity position has improved substantially since the last review. The critical point is whether or not the current position is sufficiently comfortable, especially with respect to the projected future demand of Fund resources. In making such an assessment, we must give due consideration to the possibility that tensions in international financial markets could increase, thereby exposing the Fund to an unusually large demand for resources.

The staff position in this regard appears somewhat contradictory. On page 6 (para 6, EBS/99/49), the staff seems to lean towards the negative side, essentially because: (i) the liquidity ratio is still below the pre-Asian crisis levels and (ii) it is relatively low at the present stage of the quota cycle. By contrast, in the conclusions (page 12, para. 22), the staff argues that "the Fund's resource base appears adequate to accommodate a substantial increase in demand over the staff's baseline projections, including under the CCL if established."

My sense is that the current liquidity position is indeed comfortable, for the following reasons.

- In terms of the benchmarks that we should consider for the sake of comparison, the liquidity ratio, which is currently around 90 percent, is at a significant margin above its historical norm (70 percent), and is largely above the level that is now considered as the vital minimum (25-30 percent).

- While it is true that the liquidity ratio is below pre-Asian crisis levels, it is also true that the Fund's borrowing capacity has been enhanced with the NAB, which became operational only in 1998. Hence, the Fund now has a potentially larger pool of liquidity that can be mobilized to cope with global financial instability.

- The staff anticipates an easing of the demand of Fund resources, at least over the short term, reflecting, among other things, an improvement in world economic conditions. In fact, by the end of the year 2000, the liquidity ratio should increase to more than 100 percent.

The impression that the current position is at a comfortable level is further supported by the sensitivity analysis carried out by the staff, the results of which are in Table 3 of the main paper. Let us consider the worst-case scenario, where the Fund faces an additional demand of resources for SDR 20 billion by end-2000. This is a sizeable amount indeed, considering that during the Asian crisis the Fund committed SDR 27 billion circa to the three main crisis countries (Indonesia, South Korea, and Thailand). In such a scenario, the liquidity ratio would fall to 51 percent, still much above the vital minimum of 30 percent.

We should bear in mind that such calculations do not take into account possible activation of the GAB/NAB, which is always an option under special circumstances (in fact, a sensible one). For instance, in the extreme scenario of additional demand for SDR 20 billion, should the GAB/NAB be activated for only half of their total amount (SDR 17 billion), then (end-2000) net uncommitted resources would fall from 59.7 to 56.7 and the liquidity ratio to just 70 percent (instead of 51 percent), i.e. its norm.

Proposed modifications to the current framework—General considerations

Due to the increase in the use of precautionary arrangements and the putting in place of the CCL, there is no question that our assessment of the Fund's liquidity position has become more difficult. This would be especially true during periods of financial distress, when precautionary arrangements tend to turn into normal arrangements. Because of contagion, this effect can be amplified as balances are drawn upon all at the same time. Overall, it seems likely that the liquidity ratio would be subject to greater volatility than in the past. The creation of the CCL has further increased our degree of uncertainty, if only because it is rather difficult at this stage to know how many countries would have access to the new window (albeit we would all agree that eligibility is very strict). Against this background, it is all the more important that we attach the proper weight to precautionary arrangements in the computation of the Fund's liquidity position. The essential point is how to determine this weight.

The present system is essentially based on a rule-of-thumb: it considers precautionary arrangements at 50 percent of their face value. The staff argues that this weight should be increased, and proposes to treat precautionary arrangements as normal arrangements, which would automatically raise their weight to 100 percent (the only difference being that, when projecting future demand, an assumption of no purchases would hold). The staff rejects probability-based approaches because they are difficult to implement, especially in the case of the CCL.

The impression is that the staff rejects probability-based approaches too hastily, and that in any case we need more analysis before making such an important revision in our procedure.

In the first place, on what basis can we conclude that 0.5 is too low a weight? We are not provided with any evidence, not even tentative, to conclude that 0.5 is either too big or too small a number. As a minimum, we should have more information concerning the recent history of precautionary arrangements. We are told that in 1997-1998 "several relatively large precautionary arrangements ... were activated in the context of the financial market turbulence of 1997-98" (page 2 of Supplement 1). Such arrangements consisted of only four (two for the Philippines, one for Kazakhstan and one for Uruguay). Yet, we are left without knowing how many precautionary arrangements were in place at that time, and how much was actually drawn of the total amount committed in the four cases. Such information, which could be extended to all recent crisis episodes (Mexican, Russian and Brazilian), would provide useful terms of reference (albeit still tentative) to assess the likelihood that precautionary arrangements will be activated.

The need to take account of the CCL further complicates the analysis. In the first place, we are still in the dark concerning the number of member countries that can have access (or would wish to have access) to the new credit line. Prudence would suggest that we wait before changing our procedures, and observe how the CCL works in practice. Secondly, as the CCL has been created to prevent financial crises, and as it is addressed only to members with sound fundamentals, one would expect that the probability of it being drawn upon is generally low, possibly lower than for a standard precautionary arrangement. It is thus questionable if we should assign to the CCL the same weight that we attribute to normal precautionary arrangements, and even more if we should assign the CCL a unit weight.

Further considerations on the proposed modification

Setting the weight assigned to precautionary arrangements (including the CCL) to one would have two effects on the liquidity ratio. The first effect would be that of lowering permanently the ratio, as the deduction from usable resources for undrawn balances would be larger. The second effect would be on the ratio's degree of volatility, which would also be reduced. In fact, under the current procedure, once precautionary arrangements are drawn upon, their weight automatically turns from 0.5 to one, hence the liquidity ratio may sustain a sudden drop (essentially because the numerator is sharply reduced). This drop would not occur under the new procedure, as the weight is already set at one (albeit drawings would still be reflected in the denominator of the ratio). Note that this reduction in volatility is simply a "mechanical" consequence of the change in procedure.

I am not convinced that either effect would be an advantage in terms of the reliability of our indicator.

Concerning the effect on the size of the liquidity ratio, it is well known that the ratio already tends to systematically underestimate the level of liquidity. The reason for this is that it is built under very conservative and prudent assumptions. Apart from the adjustment factor, that was recently lowered to 10 percent of quotas of the members in the operational budget, the practice of deducting from usable resources all undrawn balances under standard arrangements-to take just one example-is itself a big source of underestimation. Indeed, the practice of not drawing fully from operative arrangements is not uncommon. Against this backdrop, the risk is that the proposed modification of the treatment reserved to precautionary arrangements would further bias our indicator downward. While it is always advisable to err on the side of prudence in assessing the Fund's liquidity position, it would be unreasonable to let such a bias become unacceptably large.

No less controversial is whether the mechanical reduction in the ratio's volatility would be a positive outcome of the new procedure. In general, one would want to see the liquidity indicator varying flexibly and adequately in response to changes in the underlying liquidity position. This question is particularly relevant when we consider the behavior of our indicator in situations of financial distress, when precautionary arrangements start to be drawn upon. The impression is that the current procedure would provide less equivocal signals of the ensuing tensions in the Fund's liquidity position, as the liquidity ratio would change more significantly than under the new procedure.

A final comment concerns the zero weight assumption for purchases that would hold when projecting the Fund's future liquid liabilities. Such an assumption appears relatively innocuous under normal conditions of future demand for Fund resources. However, in situations of particular tension in financial markets, as in the event of a financial crisis, this assumption is very unlikely to hold, as one would anticipate that precautionary balances (and especially the CCL) would be subject to purchases. This leads to the impression that the staff is trying to mitigate what is clearly an extreme assumption on the numerator side (unit weight to precautionary arrangements) with the one on the denominator side (zero weight to purchases), which is, however, not less extreme. A more correct approach would be to look for more reasonable assumptions on both counts.

Conclusions

The staff has provided neither convincing arguments, nor adequate evidence on the need to change our procedure for the treatment of precautionary arrangements. The basic claim that we should raise the weight assigned to such arrangements hinges on the view that the actual weight (0.5) is too low. I think that the mistake is exactly in taking 0.5, which is only a rule-of-thumb, as the starting point. The truth is that we do not have a clue whether 0.5 is too big or too low. That was not a problem when precautionary arrangements were marginal to the Fund's activity. Now that precautionary arrangements are becoming so important to the Fund, we do need a better assessment of their potential impact on the Fund's liquidity. This implies, in my view, a more in-depth analysis than the one carried out so far by the staff. In doing this, I would not rule out probability-based approaches. At the basic level, we should give a better look at the "empirics" of precautionary arrangements and at their behavior during recent episodes of financial market turbulence. This would at least provide a starting point. In any case, it seems reasonable to wait until the first review before changing our procedure, in order to have at least a preliminary assessment of the impact of the CCL on the Fund's liquid liabilities.

Mr. Ogushi made the following statement:

The Fund's financial position has improved significantly, after a historical low in the liquidity ratio in 1998. It is encouraging that the Fund's usable resources have increased by SDR at 46 billion, following the quota increase approved under the Eleventh General Review of Quotas earlier this year, and that the liquidity ratio is predicted to exceed 100 percent by end 2000. Meanwhile, as the staff points out, international economic prospects are still uncertain, and I very much agree with Mr. Shaalan's statement that we have now entered a new era in terms of the Fund's financial assistance. The demand for Fund resources up to end-2000 might possibly exceed the baseline projection, particularly if demands made of the Fund under the CCL surge, and the liquidity position could again descend to uncomfortable levels. We should thus remain vigilant, and avoid complacency, to ensure that the Fund's financial position is maintained at a level that will allow it to respond adequately to possible economic turbulence in the future. In this regard, I wish to reiterate this chair's request that we should examine the possibility of the Fund's borrowing from the financial market in case of insufficiency of resources.

Turning to the issue of methodology, given the growth in the number of precautionary arrangements and the amounts committed, as well as the introduction of the CCL, I can support the staff's proposal on the treatment of these arrangements in assessing the Fund's liquidity. The proposed framework would be more transparent and prudent than the current one. The financial crises in Asia, and other regions, have drawn attention to the possibility that requests for the activation of CCLs could come simultaneously from a large number of countries. The Fund's liquidity ratio should thus be calculated with caution in order to assure the markets that the CCL is adequately financed and actually usable.

Mr. Al-Turki made the following statement:

The staff paper before us clearly indicates that the Fund's liquidity position is comfortable and is projected to remain so over the next year. While there are uncertainties surrounding the projections, I feel that the actual liquidity ratio may well turn out to be more favorable in view of the staff's cautious stance regarding these projections.

Turning to the weighting of commitments under the precautionary arrangements, including the CCL, I found staff's proposal to be too conservative for a number of reasons.

First, the Fund and the international community are embarking on a major effort to strengthen the architecture of the international monetary system and enhance its resilience. The increased involvement of the private sector at an early stage along with the Fund's strengthened surveillance should reduce the frequency and intensity of demand for Fund resources and spread of a crisis. Indeed, with likely lower incidence of contagion, concerns regarding simultaneous activation by many countries of their CCLs should diminish.

Second, while access to CCLs is large, actual distribution is phased. In addition, the repurchase period is relatively short. Thus, the impact on actual liquidity of CCL activation will be much smaller than the large access may indicate.

Third, in case of a crisis that required wholesale activation of CCL commitments, the Fund has a comfortable cushion in NAB and GAB resources.

Fourth, changing the weighing scheme at this stage may send the wrong signal that the Fund is expecting a larger use of precautionary arrangements and greater CCL commitments.

For all those reasons, the current weighting scheme should be retained for the time being. Of course, staff would need to monitor developments in CCLs and precautionary arrangements closely, and in light of the experience over the coming year, we will revisit this issue.

Mr. Zoccali made the following statement:

We welcome the strengthening of the Fund's quota-based usable resources, following the effectiveness of the quota increase under the Eleventh General Review, and the restoration of its borrowing capacity under the GAB and the NAB that have taken place since last September's liquidity review. The outlook for the Fund's liquidity over the next two years is unquestionably subject to uncertainty. The same applies more generally to world economic activity also subject to considerable downside risks. The high volatility in financial markets and the mechanisms for rapid propagation particularly of financial shocks increase the difficulty in projecting demand and supply of usable Fund resources for the remainder of this year and for 2000, and underscore the judgmental character of the exercise. Given staff's predisposition for conservative working assumptions, we are prepared to endorse their general conclusion that, although the demand for Fund resources is likely to remain relatively strong, the Fund's liquidity is likely to improve moderately during 1999-2000. This said, I fully agree with Mr. Ogushi regarding the need to remain vigilant in this regard.

There seems little to be gained from questioning staff's working assumptions, or the conjectural nature of the liquidity review. However, the operational recommendation advanced implying a heightened liquidity risk, since our last review, of commitments under precautionary and contingent arrangements, does not readily follow from the information in the initial staff paper, or the supplement

In this regard, the additional table provided to our office shows that actual drawings on the 41 precautionary arrangements since 1990 amounted to only 46 percent of aggregate committed access. This would, in our view, confirm that the sample was significant and, as importantly, that the current 50 percent accounting rule for precautionary commitments in the assessments of liquidity during a period of substantial financial market volatility was neither arbitrary nor systematically prone to understating the potential implications for the Fund's liquidity position, in the event that such arrangements were drawn upon.

Additionally, while it may be true that members' experiences since the onset of the current financial crises may add to the demand for precautionary arrangements, including in the form of CCLs, the possible change in the nature of precautionary demand for Fund resources in response to heightened volatility of globalized financial markets should be seen as a welcome development, potentially reducing the need for Fund liquidity rather than directly leading, as implied, to a greater possibility than hitherto of virtually simultaneous activation of several such arrangements, if international financial conditions were to deteriorate. In this regard, the signaling regarding the desirability of well-designed precautionary arrangements as an effective means of forestalling crises should be robust and consistent. The implication that "ex-ante" conditionality has zero deterrent value in preventing crises, and that it would not be appropriate to show commitments under contingent arrangements at only a fraction of the committed amount, only serves to convey to countries the message that, if they opt for this route, their vulnerability is extreme. In circumstances where the Fund's own financial conditions and liquidity accounting, lumps precautionary arrangements and CCLs with committed resources for actual crisis resolution, it is difficult to envisage any meaningful differentiation by private markets for good performance, and sufficient incentive for members to come to the Fund voluntarily and in the preventive fashion that we have agreed to promote. The proposed change in the commitment weights would not, according to footnote 1 of table 5 of EBS/99/49, alter the staff's conclusions regarding the Fund's prospective liquidity, as its effect would be to reduce the liquidity ratio by about 2 percentage points for end-1999 and 2000.

Lastly, in paragraph 14 of the supplement, staff refers to the difficulty of coming to definitive conclusions regarding the appropriate method of taking CCLs into account in the liquidity analysis and the lack of experience in this area. The intent is also expressed to keep the Executive Board informed of any development that could call into question the Fund's capacity to provide adequate support to members in need. Consequently, we consider it premature to abandon the current methodology of accounting for precautionary arrangements and, as importantly, that the internal classifications for the purpose of the liquidity analysis should bear some relationship to the envisaged effectiveness of the instruments themselves. If a modification of the commitment weights is to be advanced, we consider that it should be based on empirical experience with precautionary arrangements and CCLs. As suggested by Mr. Schlitzer, a reassessment in six months time would be desirable. In any event, a review, in conjunction with the scheduled review of the CCL, would be warranted.

Mr. Guzmán-Calafell made the following statement:

The staff paper gives rise to mixed feelings regarding the evolution of the Fund's liquidity position in coming years. On the one hand, the current trend suggests that it is reasonable to expect a moderate increase in the liquidity ratio from present levels. Indeed, the staff projects an upward trend in the liquidity ratio from around 89 percent at present, to some 105 percent by the end-2000. On the other hand, the report highlights the unusually high degree of uncertainty, and the balance of risks appears to be on the downside. There are three elements worth noting in this respect.

First, according to the staff, the liquidity position is less than comfortable for the current stage of the quota cycle. Second, we cannot be too optimistic about increases in the availability of usable resources. Under the present conditions of the world economy, the possibilities of extending the list of countries whose currencies can be included on the transfer side of the operational budget are not very great. Third, prospective world economic developments point to a potential for larger-than-expected demands for Fund support. Given the prevailing uncertainty, the staff's interest in refining the estimates of the financial situation of the Fund—in particular the accounting of precautionary and contingent commitments for liquidity purposes—is understandable, and welcome. This is not an easy endeavor, and naturally, any approach adopted to incorporate these commitments into the liquidity analysis will need to be revised in the light of experience.

As indicated on previous occasions, we believe that the CCL meets the objectives for which it was created. It should alleviate, rather than increase, the pressures on the Fund's liquidity. Therefore, one could argue that there is a basis for applying to the support provided under the CCL, the approach used for precautionary arrangements, by means of which 50 percent of commitments are counted against uncommitted resources. Nevertheless, against the background of the potential pressures on the Fund's liquidity, and the need to ensure that the Fund's capacity to provide its financial support when needed, is not called into question, this would not appear to be a prudent route to follow. Furthermore, I agree with the staff that the potentially high correlation in the activation of resources committed under the CCL, as well as the large scale of financing provided with this facility, also argue in favor of prudence.

Does this necessarily imply that a weight of 100 percent should be applied to CCL commitments for liquidity assessment purposes? There is clearly no definitive answer to this question. However, in the face of the prevailing uncertainty, I would prefer to err on the side of caution, and thus support the staff's proposal to score commitments under the CCL at

100 percent, with no presumption of purchases. For similar reasons, I believe that the use of the same approach for precautionary arrangements is warranted.

Mr. Donecker made the following statement:

Today we are discussing a paper that was issued nearly two months ago. Are the figures still fully relevant? A short update on the liquidity calculations in the main document would have been helpful.

We welcome the strong improvement of the Fund's liquidity resulting from the quota increases under the Eleventh General Review, which came into effect in January. The liquidity ratio nevertheless remains significantly below the level of two years ago, during the early stages of the Asian crisis, and was considerably higher following the quota increase under the Ninth Review. However, we should not focus solely on the evolution of the liquidity ratio. We need to take a broader perspective in order to arrive at the right conclusions on the adequacy of the Fund's liquidity.

For the time being, the Fund's liquidity seems to be adequate, but not very comfortable, taking into account the possibility of further substantial financial crises. As the staff points out, in future, the demand for Fund resources will probably be more volatile, owing to strong credit demand to overcome or prevent crises. At the same time, we should also bear in mind the effects of the Fund's strengthened surveillance, which should lead to less, rather than more, demand on Fund resources. This is a crucial point, which bears repetition. If we recommend the right courses of action, and undertake adequate surveillance, and if member countries implement appropriate policies, the demand for Fund credit should decrease, and not increase. Clearly, prudence and careful lending policies remain indispensable, even after the most recent quota increases.

In this context, we should bear in mind that the GAB and the NAB are the reserve tanks of this institution, which, as in the past, should only be used in specified exceptional circumstances. Again, I would like to stress the revolving character of Fund resources. Against this background, it is interesting to find a hint in paragraph 9 on follow-up arrangements to replace some of the currently expiring arrangements. We would appreciate staff's and management's comments on when we can expect to receive, and discuss the envisaged papers on prolonged use of Fund resources, and on the Fund's early repurchase policy. Last year, we agreed to take up the issue of the early repurchase policy after the annual meetings. I feel that it is high time that we gave due consideration to these very important policy issues.

> Finally, we fully support the staff's proposal to take full account of precautionary arrangements, and CCL commitments in the liquidity calculations. We support the staff's view that it might be difficult to apply a probability-weighted approach to CCL arrangements at this stage without any further experience. Like Mr. Shaalan and Mrs. Farid, I would like to stress that, with the proposed procedure, the effect of CCL arrangements on the Fund's projected liquidity would be only about half the impact of ordinary stand-by or extended arrangements. For the time being, we continue to be in favor of erring on the side of prudence in assessing the Fund's liquidity, despite the larger margin. We should not wait until we have more experience with the CCL before changing our procedures for calculating Fund's liquidity. However, it is our understanding that further changes at the next liquidity review should not be excluded if deemed necessary or desirable.

Mr. Taylor wondered whether, in Mr. Donecker's view, the NAB should not be available in relation to hypothetical CCL drawing.

Mr. Donecker responded that the NAB and the GAB should be made available only under the exceptional circumstances described in the text of the decisions.

The Secretary indicated that a timetable for the work on the early repurchase guidelines would be presented to the Board in October in the context of the next work program.

Mr. Couillault made the following statement:

> As I have no major difficulty with staff's evaluation of the Fund's liquidity, I will focus on the weighting of precautionary and contingent commitments in the assessment of the Fund's liquidity. I am not fully convinced by staff's arguments, and I would prefer not to modify the current approach in relation to precautionary arrangements.
>
> Staff rightly points to the increase in the number of commitments under precautionary arrangements. Staff also emphasizes that these arrangements will be increasingly drawn upon, and suggests that there could be a possible change in the nature of precautionary demand. On this particular point, I wonder if that conclusion can be drawn from the recent experiences, which took place in a context of global crisis, and, therefore, do not reflect a normal situation. I wish to recall, in this regard, that even in those troubled times, the arrangements were not fully drawn. Against this background, I do not see the need to weigh precautionary agreements at 100 percent when assessing the Fund's liquidity. There is still a major difference between contingent, and other arrangements, since the authorities have stated their intention not to draw on the resources. We need to be cautious about the message that we send to the market, and to avoid blurring the lines between the different types of commitments.

Turning to the CCL, it has always been this chair's stance that this facility should be reserved for countries with strong fundamentals, and presenting no need for balance of payments financing. Thus, we consider that there is no reason to have a more cautious approach than for precautionary arrangements. In fact, there might even be a case for according a lighter weight to contingent arrangements. However, in the spirit of compromise, we can accept applying the same weight-50 percent-to CCLs as to other precautionary arrangements. We do not yet have enough experience with the CCL, but the first review will provide us with more information to adopt a more sophisticated approach.

Mr. Collins made the following statement:

I will focus my remarks on the treatment of the CCL. Inevitably, this is a matter of judgment, and as many of the arguments in this debate seem to cut both ways, it is not obvious what conclusion one should draw. My initial impression was that the staff's approach was appropriate, but, on further reflection, I became less convinced. Mr. Schlitzer's statement has made some compelling arguments in the other direction, but there again, I am not entirely convinced. Therefore, I will simply raise a few questions, although I recognize the need to arrive at a decision. I will focus on giving my tentative views on three points. First, should CCLs be treated in the same way as other precautionary arrangements? Second, is 100 percent the right weight for the numerator in the liquidity calculation? Third, is zero the right weight for the denominator?

Contrary to regular precautionary arrangements, CCLs are meant to be reserved for countries without significant policy weaknesses. All stand-by arrangements are, almost by definition, precautionary, and some are more precautionary than others. Therefore, CCLs should be less likely to be drawn than standard precautionary arrangements. That, in turn, would imply that, for the liquidity calculation, CCLs should have a lower weight than precautionary arrangements, or, at the very least, it should be no higher. I could support with applying identical weights, but in this regard, I would also note that there are numbers between 50 percent and 100 percent, which would allow for differentiation between the two.

Turning to my second question on the right weight for the numerator, it seems paradoxical that a precautionary arrangement or a CCL should have the same weight as an arrangement that we know will be drawn. A weight below 100 percent would be more appropriate. Again, it would not have to be as low as 50 percent, as long as there was differentiation between a CCL and a precautionary arrangement, on one hand, and a regular arrangement, on the other.

My third comment is on the denominator, where there seems to be agreement that a zero weight is appropriate for the impact of these arrangements on the liquid liabilities of the Fund. In contrast to what I have just said about the numerator, the staff has been insufficiently prudent with regard to the denominator, recognizing that if one arrangement or CCL is activated, there is a high probability that others will also be activated. There is therefore a real risk there. If Country A activates its CCL, presumably, at that point, the weight in the denominator of the liquidity calculation for its arrangement goes from zero to 100 percent. At that point, would it be appropriate to leave the weights of all the other outstanding CCLs at zero? I would argue that it would not, given the risk that more CCLs will be activated. The weight for the denominator could then be greater than zero, but, again, the extent of the increase would be a matter of judgment.

The liquidity ratio would be more volatile. In itself that would not be undesirable, as it would reflect reality. The stability of the liquidity ratio is not an end in itself.

I wish to mention a few cases where I felt that Directors' statements cut both ways. I was somewhat disturbed by Mr. Al-Turki's reference to the NAB and the GAB. As Mr. Donecker rightly pointed out, the NAB and the GAB should only be used in specified exceptional circumstances. I am not sure whether Mr. Al-Turki was in favor of 50 percent weighting, but one could use his argument to show that the weight should be set at 100 percent, to bring forward the day when the Fund is short of liquidity and has to call on the NAB and GAB.

Mr. Donecker pointed out that, if we are successful in implementing the policies underpinning the CCL, then there should be reduced use of Fund resources. One could easily conclude from that observation, that a lower weight is warranted.

Finally, Mr. Shaalan states based on staff's proposal that the resultant impact of precautionary arrangements and CCLs would be only about half the impact of regular stand-by or extended arrangements. As regular arrangements have 100 percent weight in the numerator and in the denominator, I believe that, at the margin, the impact would be one-quarter, rather than one-half. I would appreciate staff's comments on this.

In closing, I would like to reiterate a point that we have made in the past, and which was also touched upon by Mr. Guzmán-Calafell, namely that one way to relieve the pressure on the liquidity of the Fund would be to widen the range of usable currencies in the operational budget.

Mr. Prader made the following statement:

The substantial strengthening of the Fund's liquidity position resulting from the quota increase is most welcome. However, our relief that the liquidity position is expected to improve over the projection period should not lead us to underestimate the risks mentioned by the staff. The staff's analysis of the sensitivity of the Fund's liquidity position to increases in the demand for its resources shows that the situation could change very quickly.

Nonetheless, we are reasonably optimistic about the Fund's near-term liquidity prospects, especially given the generally improved outlook for the global economy, the proposals for involving the private sector, and the impending inclusion of Israel and Poland reported in the Operational Budget paper.

We are not convinced by the staff's reasoning in justification of the proposal to change the accounting method for precautionary arrangements, which is based on the view that the Fund must be able to convince the markets at all times that it is able to provide the committed financing. One could equally well argue, in the opposite direction, that too much transparency on the Fund's part about its potential inability to meet large commitments stemming from activation of CCLs (and this may not be just a fiction, given the possibility that cascading activation would be triggered by another crisis of confidence) could make this facility impotent to perform as expected. Activation of CCLs on a scale commensurate with the amount of available resources is likely to lead, sooner or later, to the Fund running short of money. It is hard to imagine any other outcome. In addition, from an accounting standpoint, is there any "transparent way," to account for the "unlimited financing" which the CCL will offer according to the Managing Director's recent comments? If we want to be consistent, why did we not do this with the SRF, which is also supposed to offer unlimited financing?

From an another point of view, it makes no sense to attach a weight of 100 percent to a facility that is supposed to be offered to countries which basically do not need it, and are expected never to draw on it, while attaching a weight of 50 percent to precautionary arrangements whose likelihood of being drawn on is arguably much greater. The same objection holds for the SRF, which till now has been assigned a weight of zero for liquidity purposes, despite the fact that the likelihood of its being drawn on by a particular country is by definition much higher than the likelihood of drawings on CCLs.

The weight attached to the CCL should be lower than the weight assigned to the usual precautionary arrangements, as a reflection of the higher economic and financial qualities of CCL-eligible countries. A 25 percent weight for CCL commitments seems a reasonable rule of thumb, assuming that we leave the weight assigned to other precautionary arrangements at 50 percent.

For these reasons, we clearly cannot support the staff's proposal.

Finally, we join Mr. Donecker in asking about the papers on the early repurchase policy, but take note of the Secretary's reassurances that the paper will be discussed after the Annual Meetings.

Mr. Kapteijn made the following statement:

I will not comment on the adequacy of the current liquidity ratio, for which I would like to associate myself with the comments of Mr. Donecker and Mr. Guzmán-Calafell. I would like to focus my remarks on the proposed change in the calculation of the liquidity ratio.

The staff has adequately summarized the three main arguments in favor of the change: prudence, transparency, and consistency. The Fund's ability to provide committed financing in case of need should be beyond doubt, to provide confidence, not only to the member to which the arrangement is being made available, but also to other creditors, who may need assurances about that member's ability to meet debt and amortization payments. In addition, potential Fund debtors should have clarity on the remaining resources available to them. By changing the way we account for precautionary arrangements, we would be able to state that uncommitted resources are, indeed, uncommitted. To be crystal clear on the Fund's ability to provide committed financing is perhaps even more important under the CCL than under other arrangements, given the considerable faith that has been placed in its capacity to ward off contagion. The Fund's ability to meet its commitments must be beyond reproach, in view of the probability of simultaneous activation of CCLs, and the magnitude of the commitments likely to be involved.

One of the counter arguments that has been brought forward against this line of reasoning is that CCL-eligible members would be strong enough not to need to draw on this facility. My response to this contention would be twofold. First, I would be comfortable with this argument in a world without major financial crises such as we have experienced over the past two years. In a world in which crises do occur, and where the possibility of simultaneous activation of large, multiple CCLs cannot be ruled out, the situation becomes somewhat more worrisome. In the end, the Fund is a monetary institution, lending out central bank resources, and the overriding concern is not to provide the right signals to the market.

Second, I wish to point out that the liquidity ratio has both a numerator and denominator. On the one hand, we have committed resources and, on the other, we have uncommitted purchases. One would hope that that CCLs will, indeed, not be drawn, and it is therefore wholly appropriate to attach a zero weight to the denominator, as proposed by staff. I therefore fully support their proposed change.

Finally, I am skeptical of the probability-weighted approach for all the reasons outlined by the staff.

Mr. Newman made the following statement:

Implementation of the quota increase and the NAB has contributed to a turnaround in the Fund's liquidity from the very low levels of late last year. Moreover, greater financial market stability and early reflows from the successful implementation of SRF programs should strengthen the Fund's financial position going forward. However, volatile financial markets, the continuing downside risks for the world economy and the potential for large financial train wrecks make longer run assessments of the IMF's liquidity and financing needs particularly uncertain.

The growing use of contingent financing arrangements including the CCL and precautionary programs, increase the inherent uncertainties in assessing the Fund's liquidity. We appreciate the cautious approach the staff has proposed with regard to the treatment of contingent financing in assessments of IMF liquidity, and the difficulty of making fine judgments regarding the likelihood that various forms of contingent financing will be activated.

However, we are not entirely convinced that the recent experience of the four cases where precautionary arrangements were drawn provides a sufficient track record to make the change in approach proposed by staff. Making a full adjustment to commitments for contingent financing, but no adjustment for purchases, is tantamount to saying that there is a 100 percent probability that contingent financing arrangements will be drawn, but we are not sure exactly when. It would be more consistent with the nature of contingent arrangements to make only a partial adjustment, preferably one based on probabilities.

In this regard, I found Mr. Schlitzer's arguments persuasive although the statistical sample may still be too small to reach fine judgments either about the likelihood that contingent arrangements will be activated or that contagion situations will result in more multiple activations than one now provides for in the Fund's assessments of the liquidity effects of large SRFs or other financing arrangements. Therefore, I would see some merit in an experimental approach which could also take account of the differences between CCL and precautionary arrangements, including the higher standards for a CCL and the larger role of the Executive Board in activation decisions. Such differentiation could be achieved by adjusting uncommitted resources for, say, 50 or 60 percent of a CCL, and 75 or 80 percent for precautionary arrangements. There would be no adjustment to purchases as at present in order to avoid creating confusion with published reports of the Fund's liquid liabilities.

More generally, however, the growing importance of contingent Fund financing raises issues concerning the traditional liquidity measures and the benchmarks that are used in assessing the liquidity and adequacy of the Fund's resources. The current measures may focus on only part of the relevant factors and create a perception of precision to an assessment process that will increasingly require judgments regarding the resources available for lending and the likely calls on those resources. As we gain greater experience with the Fund's role as a provider of contingent finance, it would be useful to re-examine how the Fund assesses its liquidity and financing needs.

Mr. Rouai made the following statement:

I am concerned about the growing erosion of the specificity of precautionary arrangements, compared to the more traditional Fund programs, and about the confusion that may follow with regard to market perception. I am not convinced of the need to change the treatment of precautionary arrangements when assessing the Fund's liquidity position. My reading of the staff report reveals that precautionary arrangements remain, indeed, mostly precautionary; and those activated were for quite some time precautionary in nature. Footnote 1 on page 2 of the supplement paper indicates that the first arrangement for the Philippines was precautionary for 36 months, and the second for 8 months; the one for Kazakhstan was precautionary for 30 months, and for Uruguay, for 18 months.

Pending the actual experience under the CCL, my preference is to keep unchanged the current policy regarding the treatment of precautionary arrangements when assessing the Fund's liquidity position and to extend it to the CCL. For the future, I recommend linking the calculation of the liquidity ratio to the application of the commitment fee.

Finally, I support Mr. Donecker's comments on the issue of early repurchase.

Mr. Barro Chambrier made the following statement:

> At this stage of the discussions, I will be very brief and focus on a few points.
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> Among the major factors that have contributed to the strengthening of the Fund's financial position, I note the payments for quota increases under the Eleventh General Review, the activation of the NAB, as well as the beginning of the repurchases under the SRF.
>
> Looking ahead, it is encouraging to note that the liquidity position will continue to improve moderately during the 1999-2000, mainly because important repurchases are expected over the coming two years. However, I note that some uncertainties remain about the global economic prospects and developments in international financial markets for the remainder of 1999 and for 2000 and which continue to pose a serious problem to the projections of demand. In this regard, Figure 2 and table 3, at page 9 of the staff paper, clearly show the vulnerability of Fund's position, in the event of a higher demand of resources beyond the staff's projections. This situation underlines the need to continue to monitor closely the financial position of this institution.
>
> Regarding the issue of large commitments made under the precautionary arrangements, together with the coming into effect of the CCL, I can agree with the staff that they are a clear reflection of responses of member countries to the increased volatility in the globalized financial environment. However, we need further experiences before taking a decision to review the treatment of such arrangements for liquidity purposes.
>
> On the CCL, I note that its aim would be to help reduce the overall volatility of the Fund's liquidity, in contrast to traditional precautionary arrangements. However, given the difficulty to come to definitive conclusions regarding the appropriate method of taking CCL into account in the liquidity analysis, as indicated in paragraph 14 in the supplement paper, and the uncertainty ahead, it would be better to err on the side of caution, as suggested by the staff.

Mr. Zurbrügg made the following statement:

> The Fund's liquidity position has risen from a low and worrisome level to a more comfortable level, following the quota increase. Like other speakers, despite this welcome improvement, I believe that the liquidity ratio contains only a small safety margin. Contrary to the past, the quota increase is only slightly above the long-term average ratio of 70 percent. As in the past, the projection of the liquidity situation for the remainder of 1999 and 2000 is

characterized by large uncertainties. As underlined by the alternative scenarios sketched out in the paper, the liquidity position could quickly deteriorate again. Another factor of uncertainty is the newly established CCL. While it is clear that CCL arrangements will become increasingly important in the future, their impact on the overall use of Fund resources is still very uncertain. Furthermore, the contingent nature of the facility significantly increases the potential volatility of the Fund's liquidity position.

In this framework of increased uncertainties, I welcome the staff's proposal to modify the current treatment of precautionary arrangements for assessing the Fund's liquidity position, and to use the same approach for the CCL, as we have stated during previous discussions. We should not tolerate any overbooking of Fund resources in the context of this new facility. It is crucial that we ensure that the Fund can provide the resources it has committed, should this become necessary. By applying a 100 percent weighting for commitments under precautionary and CCL arrangements, we have taken an important step in this direction.

Mr. Harinowo made the following statement:

At this stage of the discussion, I will also be very brief. First, I endorse the staff's proposals to weight commitments under CCLs and other precautionary arrangements at 100 percent in calculating the level of the Fund's uncommitted usable resources, with a presumption of zero purchases. However, we could also support a higher weight than zero for the denominator.

In addition, I would like to stress the need to seek alternative financing for the CCL. In this regard, I wish to associate myself with Mr. Ogushi's remarks on the need for the Fund to look into the possibility of sourcing financing from the market.

Mr. Taylor asked whether the staff's proposal would have make significant differences to the current practices of the Fund.

The staff representative of the Treasurer's Department responded that the difference lay mainly in the greater transparency in the presentation of the Fund's financial position. This was particularly important now that the Fund's liquidity indicators, including data on commitments and the availability of usable resources, were being published on the Internet on a monthly basis. Although the proposed presentation would, indeed, result in a lower measured liquidity ratio, it would provide greater clarity on the level of resources available for lending. Commitments under contingent arrangements would be shown as fully committed, and only those resources which were truly uncommitted by definition would be presented as uncommitted usable resources.

The revision would not, however, change the way the Board approved or reviewed arrangements, nor the way it assessed the Fund's liquidity position, the staff representative noted. The liquidity ratio was generally not used to trigger action in any operational sense, although it could provide useful indications for the Board to take into account in assessing the Fund's resource position, thus complementing other ratios that had been used thus far. The clearer methodology would be helpful in this regard.

Mr. Taylor indicated that, as the change would have minimal operational significance, and would simply change the way the Board interpreted results, he could support the staff's proposal. He emphasized, however, that resources were either unusable or usable, and that usable resources were either committed or uncommitted, and there should not be a fourth category.

Mr. Estrella made the following statement:

As reported in the staff papers for today's discussion, the liquidity ratio rose following payment of the bulk of the quota increases and after repayment of GAB and NAB borrowing. Since then, the liquidity position has improved further.

Demand is projected to remain strong, over the next two years, but sizeable repurchases will fall due over the same period; therefore, the Fund's financial position should remain at an appropriate level. Nevertheless, the larger use of precautionary arrangements, the existence of the SRF, and the introduction of CCLs may increase the volatility of the liquidity ratio in the future. Therefore, we should be very vigilant in the future.

Turning to the issue of methodology, we should expect that the probability of the use of resources under precautionary arrangements or the CCLs should be less than one and should be lower than that of non-precautionary arrangements. In fact, one of the reasons for using precautionary arrangements or the CCLs is to reduce the likelihood of using those resources because it could increase the credibility of the authorities' economic policy. How different the probability might be, is an empirical and judgmental question which we should decide. Therefore, we must take into consideration all the points made by the Italian chair and other Directors, before taking any final decisions.

Mr. Lushin made the following statement:

The staff suggests a new accounting approach, under which a full reflection will be made of all precautionary arrangements, including CCLs, when calculating uncommitted usable resources along with the assumption that no purchases will be made under such arrangements. The arguments in favor of this new approach are clearly identified by the staff, as well as the underlying reasons for such a change. I found the supplement paper particularly useful in this regard. Of all the reasons in favor of this shift in methodology that have already been discussed by Directors, I would like to reiterate the point that, under conditions of uncertainty about the future CCL usage, it is appropriate to adopt the most cautious and conservative approach-namely the one being advocated by the staff. Until a solid track record for precautionary arrangements and CCLs is obtained, there is no analytical or statistical background for using a probability approach for precautionary arrangements, in general, and CCLs, in particular.

Moreover, the approach proposed by the staff is clear and transparent, which is particularly important in light of the increasing awareness of the general public about the financial operations of the Fund. Overall, I support the change in accounting methodology for precautionary arrangements and CCLs, as suggested by the staff.

Mr. Lehmussaari made the following statement:

First, we agree with the staff's assessment of the current situation and future demands

Second, we support the staff's recommendation to include the full amount of commitments under contingent facilities in the category of committed resources. This is a prudent step at the present time, especially after a CCL facility has been approved.

Third, a CCL decision, in addition to SRF, increases uncertainty over the possible use of the Fund's resources. The indicative access limit under a CCL of 300-500 percent of quota should be respected, while unlimited access should be treated only as a highly exceptional case. The staff report provides a good explanation of the difficulties associated with the probability-based approach to the Fund's liquidity projections. It only strengthens the view of this chair that access limits under CCLs should be viewed conservatively until we gain experience with it and the overall global economic situation improves to the extent where another bout of crises appears highly unlikely.

Mr. Charleton expressed his support for the staff's proposal to weight the commitments under the CCL at 100 percent in the liquidity analysis.

Mr. Wei made the following statement:

It is clear that the payments for quota increases under the Eleventh General Review have, to a large extent, strengthened the Fund's liquidity position. I am comfortable with the staff's liquidity projections under the assumption of no large upsurge in demand for Fund resources.

It is also true that in the past two years, our assumptions of normal situations have been proved incorrect. We should be prepared for the worst even though now there is a more optimistic sentiment. As such, I would like to reiterate the point I raised at the discussion on the establishment of the CCL: if there are unexpected pressures on the Fund's liquidity position, the GAB or NAB should be activated in a timely manner; and, if necessary, parallel lending from rich countries should be used.

I support staff's suggestion that all Fund commitments, including those approved under precautionary arrangements or the CCL, should be fully reflected in calculating the Fund's uncommitted usable resources.

Mr. Collins noted that when an SRF arrangement was approved, both the numerator and the denominator were weighted at 100 percent. He wondered if Mr. Newman had been suggesting that the likelihood of countries applying for an SRF arrangement should be estimated. He pointed out that CCLs did not enter the calculations until the Board had agreed, in principle, on providing a country with a CCL. SRFs on the other hand were no different from any ordinary arrangement, and either they were agreed, or they were not.

Mr. Newman felt that there was not much difference between CCLs, SRFs, or other financing arrangements. If there were a danger of contagion, there would be serial correlation between potential users, whether they had firm commitments, CCL commitments, or noncommitments. While recognizing that there was a greater commitment behind a CCL, Mr. Newman noted that the Board would have to make a decision on whether, or not, to actually activate the CCL. He therefore cautioned against assuming that, simply because there was contagion, all CCLs will be drawn, but that there would not, for example, be multiple SRFs.

Mr. Karunasena made the following statement:

We welcome the improvement in the Fund's liquidity. I agree with the staff's appraisal of the Fund's liquidity position and of the expected outlook. I will thus focus my comments on the proposed changes in the method for estimating uncommitted resources and for assessing the liquidity position of the Fund.

I agree with the staff that the rising number of precautionary arrangements and their increasing levels warrant a review of current methods. The staff proposal would double the weight assigned to precautionary and contingent arrangements in the estimation of the Fund's uncommitted resources. I recognize that using a probability-based approach would be difficult to implement in the case of CCLs. However, I would caution against completely ignoring the uncertainties related to the actual use of such facilities, particularly if our objective is to estimate the effects of the availability of uncommitted resources for future activities of the Fund. Even if it is difficult to estimate the probability more accurately for individual cases, we may be able to get a precise value for the system as a whole, based on available information. I would appreciate staff's comments on the possibilities of using a weighting system-reflecting inputs from the Fund's evaluation of country matters and the world economic outlook-in estimating the effective liquidity position. Until we study these issues further, it may be useful to continue using the existing system.

Mr. Jones made the following statement:

The coming into effect of the quota increase, and the restoration of the borrowing capacity under the GAB and the NAB, have created some breathing space in the Fund's financial situation. However, as noted by previous speakers, the Fund has been facing new systemic challenges in recent times, which have led to unusually high demands on its resources. The possibility of greater volatility in the Fund's liquidity position should be considered in the context of its role in crisis prevention and resolution, in a world of globalized financial markets. We can agree with the staff that, as of now, the resources appear to be sufficient to accommodate the demands. On the methodology, we can go along with staff's proposal.

The staff representative from the Treasurer's Department noted that the issue of how to deal with the increased uncertainty regarding the potential use of Fund resources was unlikely to be resolved in a probabilistic framework. In particular, experience offered little guidance for the Fund's liquidity management in the presence of CCLs. Although the overall demand for Fund resources might, indeed, be lowered by the existence of CCLs, this observation did not lead to clear operational conclusions regarding the assessment of commitments during the pre-crisis period. Forecasting would clearly become more complex.

An important issue would be how to evaluate the prevailing liquidity ratio for projection purposes, the staff representative noted. While one approach might be to adjust both the numerator and the denominator, as suggested by some Directors, from a computational viewpoint, this would not necessarily make much difference. One hundred percent scoring of commitments, as suggested by the staff, effectively meant taking into account 50 percent of the eventual liquidity impact since purchases were scored at zero. A broadly similar result could be obtained by, for example, scoring the numerator (commitments) at 75 percent and the denominator (purchases, which translated into liquid liabilities at 25 percent). However, this might be seen as merely fine-tuning around a figure, the interpretation of which, in any case, required a significant degree of judgment, taking into account a whole range of factors. Whatever approach was ultimately favored, it was important to provide an appropriate and transparent presentation of the Fund's financial position to the public. The resulting figure should also be such that it could be interpreted by the Board in a way that was consistent with the underlying computational approach while providing a basis for judging the adequacy of the Fund's current and prospective liquidity position.

As regards the recent evolution of the liquidity position, the staff representative noted that developments had been consistent with expectations. The liquidity ratio was now at 96 percent-somewhat higher than three weeks previously-essentially because of large advance repurchases by Korea, and a recent payment for the increase in quota of a member included in the operational budget and thus an increase in usable currencies. Based on current assumptions, the staff did not see any reason to change the projections for 1999/2000.

Mr. Harinowo requested staff to comment on the possibility of the Fund seeking financing from the market. He felt, that in this way, the Fund could perhaps, re-insure the risks related to CCLs. Mr. Harinowo wondered whether this would be a way of hedging of one instrument with the another.

Mr. Donecker noted that one of the strengths of the Fund was that there was a wide consensus among members that quotas were the essential and central element of Fund financing, with the GAB and the NAB as reserve tanks. In his view, the Fund had to preserve this cooperative spirit, although there would always be possibilities, if membership support was felt to be flagging, to agree to appropriate quota increases, and to determine new lending or borrowing policies, bilaterally or multilaterally, from central banks or governments, and possibly from the financial markets.

Mr. Wei noted that as an official institution the Fund should continue to rely mainly on official sources.

Mr. Kapteijn wondered if under CCLs, the members would still have to state explicitly that the arrangement would be treated as precautionary, as was currently the case for precautionary arrangements, or whether this would be implicit.

The staff representative from the Treasurer's Department noted that, by definition, a CCL could not be drawn, unless and until the Board had established that there were grounds for activation. CCLs would therefore be treated as precautionary.

Mr. Donecker suggested that if staff's proposal was not supported by a clear majority, the Board could agree that during an interim period both the former, and the proposed, liquidity ratio definitions could be adopted.

The staff representative from the Treasurer's Department confirmed that it would be relatively easy to use both definitions, but stressed the importance of clarity and simplicity in the way the Fund's financial position was presented to the public.

The Secretary stated that there was a slight majority in favor of the proposal, but not unqualified approval. Some of the speakers had expressed serious reservations, and a large group of Directors, including some of those in favor of the proposal, had called for further analysis. He suggested noting the spectrum of views in the summing up, and then returning to the issue at the time of the next review of the Fund's liquidity position.

Mr. Schlitzer agreed that, as there was no broad consensus on this proposal, which represented an important change to longstanding procedures, it was preferable to postpone the decision, until further analysis had been undertaken.

Mr. Zurbrügg, while open to the idea of recommending further analysis, wondered if there was much scope for such analysis. If not, then a decision had to be taken immediately.

The staff representative from the Treasurer's Department confirmed that the staff would continue to examine the issue, including through stress testing. Experience, however, was unlikely to provide good guidance over the next year. In the longer term, particular cases of CCL activation might provide some direction on which side, if any, to err.

Mr. Taylor wondered how CCLs would be treated in the meantime. He agreed with Mr. Zurbrügg that the Board should attempt to settle the matter, and reiterated his willingness to join the consensus.

Mr. Donecker felt that it would be preferable to simply report on the spectrum of opinions expressed, and to hold another discussion at a later stage.

Mr. Prader also called for further reflection, particularly in view of the additional information referred to by Mr. Zoccali on the activation of precautionary arrangements.

Mr. Schlitzer recommended that CCL commitments be weighted at 50 percent until more experience had been gained.

Mr. Collins supported Mr. Donecker's idea of showing both liquidity ratio definitions to ensure some continuity until a decision had been taken, but emphasized the need to agree which one would be preeminent. He recognized that gathering sufficient empirical data to undertake further studies would take time. Even if CCLs were agreed, they would not necessarily be activated, and there might be no contagion effect. Mr. Collins nevertheless agreed with Mr. Taylor, that as long as the Board had a clear understanding of the basis on which the arbitrary numbers were being calculated, it could interpret them accordingly.

Mr. Newman stressed the need to avoid publishing multiple liquidity ratios. If there was not sufficiently strong support for a change, then the status quo had to be maintained, for both CCLs and precautionary arrangements, until more experience had been gained. In a year's time, when CCL arrangements and the Fund's liquidity were being reviewed, there would be a few more cases to refer to in making a judgement on the way forward. In addition, Mr. Newman reiterated his concern that some differentiation between precautionary and CCL arrangements would be useful and desirable.

Mr. Schlitzer also cautioned against publishing multiple liquidity ratios. Further analysis was clearly needed, and the experimentation had to cover more than just the 100 percent weight, as it was not clear how valid the 50 percent assumption was. He suggested experimenting with other weights such as a 25 percent weight, for instance.

Mr. Ogushi also agreed on the need to avoid publishing multiple liquidity ratios, and to consider alternative weights in the analysis.

The Acting Chairman made the following concluding remarks:

> Directors broadly agreed with the staff's assessment of the Fund's current and prospective liquidity position and financing needs. They noted that the January 1999 quota increase had resulted in a significant improvement in the Fund's liquidity position from the historical low reached late last year, in the wake of sustained crisis-related demand on the Fund's resources. The payments for the quota increase augmented the Fund's usable resources by SDR 46 billion, and allowed the Fund to make early repayment of the borrowing under the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB). The Fund's liquidity ratio has recovered to over 90 percent.
>
> Looking ahead, Directors agreed that the recent recovery in the external financial situation of some of the countries affected by the crisis promised an easing of demand for Fund resources from the exceptionally high levels seen during the recent past. A continued moderate improvement of the liquidity position was expected, as sizeable scheduled and expected repurchases, including repurchases under the Supplemental Reserve Facility (SRF), would broadly offset continued relatively strong demand for the remainder of 1999, and for 2000. Nevertheless, global economic prospects and developments in international financial markets remained a source of uncertainty. Moreover, as demonstrated by the experience of the past two years, episodes of further financial strain in the system raised the possibility of large, and potentially simultaneous, calls on Fund resources. Thus, deterioration in the world economic situation and/or renewed bouts of financial market turbulence could quickly place the Fund's liquidity under pressure. Therefore, the Fund needed to maintain adequate liquidity and avoid complacency about potential developments.
>
> Regarding the newly established Contingent Credit Lines (CCL), views differed on the question of how best to reflect commitments under the CCL in presenting the Fund's liquidity position.

A number of Directors considered that the objectives of prudence and full disclosure would be best served by taking full account of commitments under the CCL, and other precautionary arrangements, in calculating the level of the Fund's uncommitted usable resources. Those Directors emphasized that the Fund's ability to provide the committed financing had to be beyond doubt in order to be fully convincing to markets, as any uncertainty about the Fund's capacity to provide the contingent financing when needed could risk undermining the role of the CCL. They also felt that a lower scoring of commitments could give rise to an undue sense of "comfort" with regard to the adequacy of Fund resources, particularly since no allowance would be made for the possibility of future purchases.

A number of other Directors expressed concern that a 100 percent weighting would tend to overestimate the underlying demand for Fund resources, particularly if the CCL proved to be an effective preventive tool and was rarely activated. Within this group, some Directors felt that the CCL might reduce the demands on the use of Fund resources. Some considered that the traditional 50 percent weighting remained appropriate, striking a reasonable balance between the right of a member to draw resources in the event of financial contagion and our expectations that such drawings would be infrequent. Some Directors argued that there should be a differentiation between precautionary and CCL arrangements, or alternative weights.

Given the spectrum of views, and the request by some Directors for further analysis, I would suggest that we retain the present weighting method for precautionary arrangements and the CCL, and return to the issue at the time of the next review of the Fund's liquidity position.

5. RELEASE OF INFORMATION—KINGDOM OF THE NETHERLANDS—ARUBA—1999 ARTICLE IV CONSULTATION DISCUSSIONS

The Executive Directors considered a request by the Netherlands and Aruban authorities for authorization to release publicly the staff report for the 1999 Article IV consultation discussions with the Kingdom of the Netherlands—Aruba (EBD/99/59, 5/7/99).

Directors agreed, with six objections, that the staff report for the 1999 Article IV consultation discussions with the Kingdom of the Netherlands—Aruba may be included in and published according to the pilot project for the publication of Article IV consultation staff reports that was approved in principle by the Executive Board on April 5, 1999. In that regard, Directors also clarified that a staff report based on discussions with a member which were concluded before April 5, 1999 may be included in the pilot project (but excluded from the evaluation thereunder), provided that the next Article IV consultation with that member is expected to be conducted on a 24-month cycle.

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

I would like to thank the staff for issuing a short paper that can provide some guidance for today's discussion on the proposed publication of the staff report on Aruba. In particular, the Attachment with the draft decisions on Transparency and Fund Policies is helpful in setting out the proposed modalities of the new policies the Board has decided upon on April 5, 1999. As several Directors suggested during our May 7 discussion on Aruba, these draft decisions can be expected to clarify the issue and provide the proper context for a more fruitful discussion today. I certainly hope this will lead to a clear, final and justifiable decision on my authorities' request, which was originally submitted to management and the staff on April 22, 1999.

Let me set out here some arguments in addition to the staff's statement, which the Board may wish to consider.

I acknowledge the Board reached a carefully crafted compromise on Transparency and the voluntary release of Article IV staff reports during our meeting on April 5. I do not wish to reopen this discussion again, nor do I wish to break away from the consensus. I would like to point out, however, that both the staff and the majority of Directors supported voluntary publication of the staff reports at that time. In view of the concerns of some other Directors, the Board agreed to the publication of staff reports on a trial basis for 18 months through a pilot project. The spirit of the discussion was, in my view, that every single country that wanted to do so, could have its staff report published during this period.

The point is that cases such as Aruba were never considered by the staff or the Board at that time. Thus, we did not discuss the possibility of countries that had completed their consultation but still had to have their report discussed by the Board. Nor did we discuss the special case of countries on a two-year cycle that would fall outside the 18-month scope of the pilot. I believe the principle of equality of treatment of countries could be violated if such exceptional cases as Aruba would have no opportunity to publish whatsoever. Not only Aruba's latest staff report is excluded now, but also the next one. In my opinion, the omission to accommodate some 24-month cycle cases could be fairly easily fixed, without jeopardizing the "cleanliness"of the pilot.

I believe the least contentious way to solve Aruba's problem is to change the decision on the pilot, by creating a subgroup. We could keep the pilot clean by cleaning the data-set at the end of the pilot period, which would be a normal procedure in any statistical evaluation. Therefore, the decision could explicitly stipulate that cases such as Aruba will be left out of the evaluation of the pilot. This could be done by adding for example one of the following sentences to the draft decision on Transparency and Fund Policies:

a. "It is understood that those countries that wish to participate in the pilot, but for which the staff consultation had already been concluded on April 5, 1999, be allowed to do so, but that they will be excluded from the evaluation of the pilot"; or

b. "It is understood that those countries on a 24-month cycle that wish to participate in the pilot, but for which the staff consultation had already been concluded on April 5, 1999, be allowed to do so, but that they will be excluded from the evaluation of the pilot".

The first sentence would cover some more borderline cases. The staff's comments on the number of countries falling into these categories would be appreciated.

The other option is publication on a stand-alone basis, i.e., outside of the pilot project. While leading to essentially the same result, this could be perceived as creating a precedent, as it would depart from standing Fund policy. I am not asking for an exemption of existing policies, however, but to remedying a potential inequality of treatment. Thus, stand-alone publication would be another viable option if it were crafted as a generalized Board decision, allowing this option to all countries in similar circumstances. The draft decision in the Attachment should then be amended in a way similar to the ones mentioned under 3. above.

Both options would be agreeable to me and - as it emerged during our May 7 discussion on Aruba - to the majority of the Board. I would hope that today we shall not have a proxy transparency debate again. The pilot project should not be seen as a goal in itself, but as a means to an end. In any way, I see some scope for narrowing down and detailing the proposed decision, including establishing modalities for the evaluation of the pilot. This would also obviate the need to have similar discussions in the future on other cases of countries that are interested in publication and that fall into a similar gray area.

Finally, I would like to note that the PIN for Aruba is ready for publication. I have put its release on hold pending the outcome of today's discussion. I would like to reiterate the reasons why publication of the staff report is particularly important for Aruba.

Being a small island economy, Aruba has had a continued policy of public transparency over the past years. The government's positive attitude to transparency is evidenced by the fact that Aruba was the first country for which a PIN was issued in 1997. In March this year, the Aruban authorities published the full concluding statement of the mission. Economic developments also indicate that the policy of transparency has served the country well, as it has increased confidence of external investors and financiers. It is well known that smaller countries in particular are sensitive to changes in investor sentiment. The authorities feel that publication of the full staff report, with its constructive recommendations, would further enhance their international stature as well as domestic public ownership of macroeconomic policies. The latter is an important element for the government's efforts in reestablishing good public governance to be successful.

The staff representative from the Policy Development and Review Department said that there were five countries with 24-month consultation cycles where the Article IV consultation discussions had been completed by April 5, 1999, yet their Board meetings had not taken place by that date. Those countries would thus be excluded from the pilot project. Those countries included Aruba, Bhutan, Iceland, Kiribati, and Netherlands-Antilles. A sixth country possibly in that category was Malta. Of those countries, Iceland had already come to the Board, and there had been no request to publish its Article IV staff report. The issue of publication of the staff report had not arisen so far in the other cases besides Aruba's. There were four additional countries with 24-month consultation cycles that would be excluded from participating in the pilot as it was currently drafted. In those cases, the Article IV consultation discussions and the Board meeting had both been concluded before April 5, 1999, and thus the countries would not return to the Board before the end of the 18-month pilot program. Those countries were Libya, Samoa, San Marino, and St. Lucia.

Possibly 15 to 20 countries were on a 12-month consultation cycle but their Article IV consultation discussions had been completed before April 5, 1999, the staff representative continued. All of those countries would have the opportunity in the next year for their staff reports to be part of the pilot. For example, in the case of Italy, the authorities were clearly in favor of participating in the pilot program, although their discussions had straddled the April 5 date. The Italian authorities were clearly content that the 1999 staff report would not be part of the pilot program, but the 2000 report would be.

The main question was whether the pilot project would address the concerns expressed by Executive Directors in the Board meetings of March and April, the staff representative explained. Directors had especially been interested in the candor of the discussions that would take place in the field, and the nature of the staff report itself, given advanced knowledge of publication. Those were the criteria that the staff had been looking at to assess whether a country should be part of the pilot project. The aim of the pilot project, as interpreted from the April 5 meeting, was for the staff to collect enough evidence to assess that question. The intention was not to get as many countries as possible to participate in the pilot project. The initial staff suggestion, which had not been accepted by a large enough majority of the Board, was to have a period of voluntary release, but that principle had not been incorporated into the pilot project.

There had so far been indications from 17 countries interested in participating in the pilot project, the staff representative reported. In addition, the staff was currently assessing the status of four or five other cases. The first case under the pilot project was expected to be Trinidad and Tobago, which would come to the Board by early June, 1999. Its staff report had already been issued.

The Acting Chairman said that the staff statement had suggested that if the Board agreed to release the Article IV staff report for Aruba, the draft decision should be amended. Could the staff from the Legal Department elaborate on that issue?

The Deputy General Counsel said that it would be necessary to make the Board's transparency decision consistent with the release of the staff report for Aruba. Therefore, the Board's intention as to whether to allow the release of Article IV staff reports, despite the decision approving the pilot project, needed to be clarified. If it was decided that there should be an avenue for the ad hoc or general release of Article IV staff reports, then the criteria for that ad hoc decision should be specified.

The Acting Chairman pointed out that the original staff proposal for the publication of staff reports on a voluntary basis had been rejected by the Board in favor of the pilot study. Thus, there was no case for the general release of staff reports. Instead, the Board was discussing the stand-alone publication of the staff report for Aruba and perhaps some other, limited cases.

Mr. Chelsky said that he had understood that the Board was discussing whether Aruba's participation in the pilot project would be considered consistent with the Board's decision, and, if not, whether the Board should make an exception for that country. Was that the staff's interpretation of the question?

The Acting Chairman clarified that the Board was discussing the proposal that authorization be given to release the staff report for Aruba, as stipulated in EBD/99/59 on a lapse-of-time basis, but which one Board member had requested that the Board discuss.

The staff representative from the Policy Development and Review Department said that the staff's interpretation of the April 5 Board meeting was that the pilot project would be exclusive and would not allow for staff reports to be released ad hoc during its 18-month period. The staff had also interpreted that Aruba, for the reasons already given, would not be part of that pilot project. The drafting of the language of the decision had been consistent with that view.

Mr. Donecker said that he recalled that toward the end of the April 5 discussion, the Board had clarified that the pilot project study would start from that date and could only include those countries that said on that date that they were willing to participate. Thus, any country that had earlier discussions with the Fund or had concluded an Article IV consultation was excluded. No Director had objected to that condition. For the pilot study to remain pure, it made sense to say that only those countries whose consultation discussions started after April 5 could participate in the pilot project or publish their Article IV staff reports in the context of that project, and Aruba was not among them. Although Aruba was on a 24-month consultation cycle, there was no room for that country to be included in the pilot project.

Mr. Shaalan made the following statement:

I have two serious problems with the issue of the publication of Aruba's staff report. The first difficulty is procedural, but important. In the context of the Article IV consultation discussions of Aruba on May 7, Mr. Wijnholds requested that the staff report be published. That request was discussed at that meeting. However, it is my understanding that no item can be added to the Board agenda on the same day that the request is made, unless there is unanimity for including that item on the agenda. Clearly, that was not the case when Aruba's request was put to the Board on May 7. Accordingly, I believe that any decision taken on that day is irrelevant to today's discussion. At worse, the decision could well be null and void. I would appreciate the staff's views on these observations.

My second point is of substance. During the March and April meetings on transparency and Fund policies, we had lengthy, detailed, and comprehensive discussions on the voluntary release of staff reports for Article IV consultations and the use of Fund resources. It is my understanding that what was agreed was that any voluntary release of staff reports during the next 18 months would have to be within the pilot program. The publication of Aruba's staff report as a stand-alone case clearly goes against such an understanding.

It is clear, as has been elaborated by the staff, that a country's intention to participate in the pilot program must be indicated prior to the Article IV consultation discussions. The purpose of that is well known, and it is the rationale for the pilot project: to see how candid the discussions are when the country knows that the report will be published. Including Aruba in the pilot program would certainly not fulfill that objective, as the discussions took place before the decision on the pilot program was taken. The issue of publication was unknown to the authorities and to the staff.

Accordingly, I have considerable difficulties with the two options mentioned by Messrs. Wijnholds and Houtman. First, I do not believe that the spirit of the April 5 discussion, as Mr. Wijnholds maintains, was that every single country that wanted to could have its staff report published during the 18-month project period. My understanding is the complete opposite of that. I also find the proposal to change the decision on the pilot project by creating a subgroup or allowing publication of the staff report on a stand-alone basis

> unacceptable. This Board can change anything it wishes, and any decision it has taken, but it would be unfortunate if we were to change a decision after a careful compromise has been reached. I would like to call on the Legal Department to see if the decision or the action taken on May 7 is relevant, and was legally correct.

Mr. Houtman disagreed with Mr. Shaalan's remarks on procedure. The first request by Mr. Wijnholds for publication of the staff report was made on April 22, by way of a memo to the staff and the management. Furthermore, 24 hours before the May 7 Board meeting, Messrs. Houtman and Wijnholds had issued a statement indicating their request to raise the matter. There was no reason why that issue could not have been discussed during that meeting.

The Deputy General Counsel, in response to questions and comments, made the following remarks:

> Mr. Shaalan has raised a technical question relating to the composition of the Board agenda. As Executive Directors know, the agenda is distributed in advance, upon the initiative of the management, and shall include any matter suggested by an Executive Director in due time for distribution to the Board. Under rule C8, if a Director proposes to discuss a matter that is not on the agenda, there must be a decision to add that item to the agenda, and there must be the unanimous consent of all Executive Directors present. Thus, I would agree with Mr. Shaalan's premise.
>
> I would add, however, that if, during a meeting of the Executive Board, all Directors present agree to an addition to the agenda, the Executive Board could waive the necessity for advance notice. It is my understanding that at the May 7 meeting, some Directors did not agree to the inclusion of the publication item, and it was the position of the Chairman that the item was not germane to the item already on the agenda; therefore, a new agenda item was added. In that situation, there was not unanimous consent. However, I would note that there was no decision taken at the meeting on May 7. The approach of the staff, in response to Mr. Wijnholds's request, was that the matter be taken up as a separate item, and the subsequent paper proposed a lapse-of-time procedure.

Mr. Shaalan acknowledged that there was no decision taken on May 7, but a proposed decision had been put to the Board on a lapse-of-time basis. That was the questionable procedure. While Mr. Wijnholds had raised the subject on April 22, that was not the same as putting the item on the agenda, which required an entirely different procedure.

The Acting Chairman said that the proposal to issue a lapse-of-time decision had been made by the Chairman, and it had not been up to the Board to make that proposal.

Mr. Shaalan remarked that he had some difficulty accepting the issue of considering an item that was not on the agenda for Board approval.

The Acting Chairman said that the staff and management could make a proposal without the initial consent of the Board. That was the established procedure; there was no flaw.

The Deputy General Counsel added that the relevant procedural issues had been discussed with management, and that it had appeared legally appropriate to proceed in that fashion.

Mr. Al-Turki made the following statement:

> Let me first thank the staff for a well-written and concise restatement of the basic issues regarding Aruba's request at this stage for voluntary release of the report on the 1999 Article IV consultation discussions. Let me also add that I share Mr. Shaalan's understanding on the procedural issue of adding items to the Board agenda, be it a decision or a proposal to release a report.
>
> That said, I agree with the staff that the report in question is ineligible for release under the existing decisions of the Board. I also agree that going along on compliance with such a request is inconsistent with the agreed procedures and practices regarding the purposes and methods of the 18-month pilot project that the Board launched on April 5, 1999 for guidance on the voluntary release of Article IV consultation reports. Further, I fully endorse the view that creation of a separate subcategory within the pilot project to accommodate such a request is irrelevant to the pilot project's purposes and will compromise the fairness of the sample for the project.
>
> The pilot project is indeed a means to an end, which is to provide a framework for assessing Executive Directors' concerns over voluntary release of Article IV reports, including in particular the impact of publication on the candidness of the discussions with members and the frankness of the reports by the staff. It is thus not intended as a vehicle, in and by itself, for any such purpose as transmission of information to the public. Therefore, ad hoc modifications of the pilot project to suit specific requests of individual members will definitely undermine the letter and the spirit of the Board's entire agreement on this matter.
>
> Clearly, the Board created the pilot project as an experiment for guidance to determine what the next stance of this institution is to be on the question of the voluntary release of Article IV reports. It is thus inappropriate to proceed as if the next step can already be anticipated before the pilot project has been carried out as agreed. Indeed, it is on such critical considerations that the Board has already rejected earlier requests by Directors for voluntary

publication of reports on consultation discussions held before the launching of the pilot project. The important principle that the Board has upheld is that reports to be released should only relate to discussions held with prior knowledge by the authorities and the staff that such reports would be published.

Let me turn next to the notion of accommodating requests at this stage for voluntary release of Article IV reports on a so-called "stand-alone basis." Again, such ad hoc acceptance of requests for release undermines the entire basis of the agreed pilot project for assessing the questions raised over publication of staff reports. Such compliance clearly is contrary to the existing Fund policy not to release staff reports. Accordingly, it would require a specific decision of the Board and a modification of the pilot project. This chair is opposed to such reopening of issues that this Board has already discussed and agreed on.

In conclusion, I remain of the view that the appropriate course always is to respect the Board's existing decisions and practices. Therefore, any such request at this stage for voluntary release of an Article IV report should be denied.

Mr. Schlitzer made the following statement:

The present discussion has implications that clearly go far beyond Aruba's specific request. We should be guided by two principles. The first is, for the sake of consistency, to take fully into account possible reflections on our strategy towards greater transparency in the Fund, and most notably on the pilot project. The second principle is to assure that members are treated on an equal footing. Hence, if we are to grant an exception to Aruba in virtue of some special conditions, we should do so for all members that share those special conditions.

Concerning the first point, we must avoid contaminating the pilot project by all possible means. As the pilot project is an empirical experiment, and we will base our final judgement on such an experiment, it is essential that it be conducted in the most rigorous manner possible. A critical precondition is that the country missions take place after the approval date of the project, to make sure that the national authorities know for certain that the report is going to be published. Note that this is a condition that also holds for countries that are already part of the pilot project. Italy is a case in point, as mentioned by the staff.

This being said, we cannot ignore that there is a group of countries willing to see their reports published that are at a clear disadvantage. These countries are on a twenty-four month cycle and cannot be part of the pilot project because their Art. IV consultations fall outside the time span of the pilot project. Aruba, as well as a few other member countries, fall in this category. For the principle of equality of treatment, we do have to accommodate the wishes of these members.

In this regard, of the two proposals on the table, we favor the one that would allow an exception for the members belonging to this category, granting permission for the voluntary publication of their Art. IV reports. Such an exception would be limited to the duration of the pilot project.

We strongly prefer this option to the alternative of forming a special subgroup within the pilot project. Not only do we not see much usefulness in the latter, but we are also afraid that it would contaminate the pilot project itself, a risk that we must avoid. Even if we establish ex ante that the subgroup would not be part of the final evaluation process, as suggested by Mr. Wijnholds and Mr. Houtman, we would have included in the pilot project some countries that do not fulfill--or that we are not 100 percent sure that they fulfill-- the preconditions for being part of the experiment. Yet, as they are still under the umbrella of the pilot project, who could guarantee that the evidence pertaining to such a subgroup would not be used improperly by those who have an interest in doing so? I see this risk especially in the case of the evidence pertaining to the main group conflicting with that pertaining to the subgroup. By contrast, keeping such cases outside the pilot project would indicate without risk of ambiguity that they are not part of the experiment.

In synthesis, we would prefer that Aruba not be included in the pilot project, even if only in a special category. We do however support publication of Aruba's Art. IV consultation report if outside the pilot project and on an exceptional basis, within the context of a general exception to be granted to all members that, like Aruba, are on a twenty-four month cycle and do not have the opportunity to be included in the pilot project.

Mr. Shaalan asked for the staff's clarification as to whether the publication of Aruba's staff report on a stand-alone basis was counter to the understanding that the Board had reached in its discussions in March and April on transparency and Fund policies.

The staff representative from the Policy Development and Review Department said that such publication would differ from the April 5 compromise, that the pilot project would preclude the publication of staff reports on an ad hoc basis. A number of countries at that meeting had indicated their desire to publish their staff reports. However, those were countries with 12-month consultation cycles, where the consultations had already been, or largely been, concluded, so there would be an opportunity for them to participate in the pilot project in the coming year.

It was not necessary to have an enormous sample of countries for the pilot project, only to have a sample that was large and diverse enough to answer the questions raised by the Board in that April 5 meeting, the staff representative continued. Furthermore, the criteria would not allow any country that so desired to release their staff report during the project period.

Mr. Collins wondered whether the staff could refuse a country wanting to participate in the pilot project if it complied with the rules of that project.

The staff representative from the Policy Development and Review Department responded that the staff had not considered that possibility. With 17 to 20 countries so far having indicated an interest in participating in the pilot project—and given the possibility that some countries would decide at the last moment that they did not want to publish their staff reports—the staff was still encouraging countries to volunteer. The principle was to get enough countries to participate, thus providing sufficient evidence to enable the staff to carry out the pilot project successfully.

Mr. Donecker said that the staff had confirmed his understanding that on April 5, the Board had agreed to a carefully drafted compromise to undertake the pilot study. During the pilot period, no publication of Article IV staff reports would be allowed. If a month later that understanding was amended, any Director who felt overruled on a subject in a Board meeting could ask for that subject to be put on the agenda again, effectively reopening the discussion. The Board should retain the pilot project, with no exceptions. Mr. Schlitzer's question of equal treatment was not persuasive. Any country that fell within the time frame of possible participation could be part of the pilot project, while those that were not within the time frame could not. That represented equal treatment for every country.

Mr. Eyzaguirre made the following statement:

> There is no doubt in my mind, as Mr. Shaalan was saying, that to allow the publication of this staff report on a stand-alone basis would clearly contradict the views held by the Board regarding the pilot project. If we have a pilot project but a number of countries release their staff reports, then our carefully crafted compromise would make no sense.
>
> Having said that, the point made by Messrs. Wijnholds, Houtman, and Schlitzer about the equality of treatment is compelling. I was not aware at the time of the April 5 decision that countries with 24-month consultation cycles would be excluded from participating in the pilot project. I am concerned about the staff's statement that the project is not a scientific experiment, that it should only include a representative sample of countries. Some countries may not be indifferent about whether they are included in the sample. We are not proceeding along the lines of equal treatment if we do not accommodate the countries with 24-month consultation

cycles. I wonder whether a simple way out of this dilemma would be to lengthen the period of the pilot project to 24 months.

Mr. Taylor was confused by the staff representative's answer to Mr. Collins's question about whether any country could join the pilot project if it fell within the rules. One country, Kiribati, would presumably be affected in the same way as Aruba. Samoa would be excluded because it was on a 24-month cycle and would not return to the Board within the 18-month period of the pilot project. The Board could extend the project period to 24 months, or, in the interest of transparency, reduce the 24-month consultation cycle to a 12-month consultation cycle for such countries.

While the draft decisions were said to be only for information, time was passing, and a decision was needed within a week, Mr. Taylor commented. One country, for example, had to be advised in the next few days whether to release a letter of intent, which would require the consideration of the country's cabinet. Another country faced a decision about whether to participate in the pilot project. Apparently such a decision was required at least at the outset of the mission, which was imminent in that case. It would therefore be good to know the timetable in relation to those draft decisions.

Mr. Collins shared Mr. Taylor's confusion. The staff had clearly said that the pilot program was not open to any country that wanted to participate, only that there was a desire to obtain a suitable sample and that not many countries were needed. It was difficult to understand the staff's response to the question about whether a country could be refused permission to join in the pilot project. How many countries on 24-month consultation cycles would fall within the pilot project period?

The staff representative from the Policy Development and Review Department said that the staff would not discourage more countries from joining the pilot project. In fact, the staff was encouraging more countries to participate, and would be happy if there was a larger sample than at present, especially for matters of diversity. Mission staff were being encouraged to speak to the authorities and urge them to participate. The staff were making sure that there would be a sufficiently large sample over the period of the next 12 months to carry out the necessary evaluation. There were some countries that would not qualify, such as those on the 24-month consultation cycle, which would not fit under Option B proposed by Messrs. Wijnholds and Houtman. There were four such countries for which the staff consultations and Board discussion had already taken place and that would not come back to the Board within the pilot project period. That was the nature of the timing of the pilot project. The overall aim was not to try to devise the pilot project to include those countries. In response to Mr. Collins's question, about half of the countries on 24-month consultation cycles would fall within the pilot project period.

Regarding the possibilities raised about how the pilot program could be modified, extending the pilot project by making it a 27-month pilot project would facilitate incorporation of all the 24- month cycle countries, the staff representative confirmed. While the 24-month consultation cycle cases were not discussed in detail at the April 5 Board meeting, it was understood that after 12 months there would be sufficient evidence from the countries that were in the sample to make the necessary assessments. It was clear that not all of the countries could be included under the terms of the pilot project.

Regarding the timing of the draft decisions and their implications for a number of other issues, the staff had intended, following the meeting, to circulate the decisions to the Board for lapse-of-time approval, which would be in the next few days, the staff representative reported. After the Board discussion of April 5, the staff had asked for a period of time to determine all of the modalities of the pilot project. The discussions since then had demonstrated the importance of making sure that the Board members were in concurrence. The goal was to try to get all of the new modalities into place by the following week.

The staff had been working on the assumption that it should be clear to the authorities and the mission staff, as close to the beginning of the discussions as possible, that the Article IV staff report would be published, the staff representative remarked. In the case of some countries, the consultation discussions had started before April 5 and had not concluded until after that date. That would involve a judgment call regarding the substance of those discussions. By the time that the Article IV staff report was drafted by the staff, both sides had to be clear about whether that report would be issued.

Mr. Newman asked whether it was feasible or desirable to conduct an Article IV consultation in Aruba again in 12 months, so that that country could be incorporated into the pilot project without disturbing the sample. It was regrettable that such an option would be resource-intensive for the staff, but that might be an amenable solution to the problem.

Mr. Houtman responded that it would not be appropriate to have another Article IV consultation for the sole purpose of having the resulting report published. That would be an inappropriate use of Fund and staff resources, given that was no other economic need to hold those discussions. There were reasons why Aruba was on a 24-month cycle. Furthermore, such a proposal did not solve the problem, because the Aruban authorities wanted to publish the current report immediately.

The cases of the 24-month consultation cycle countries were not discussed at all in the April 5 meeting on transparency, Mr. Houtman commented. Most Directors did not realize that that issue existed, nor did the staff. To not include Aruba in the decision was not fair, because the country could not participate at all.

The staff's suggestion that his proposal would go against the spirit of the April 5 compromise was a matter of personal interpretation of that meeting, Mr. Houtman remarked. During that meeting, a majority of Directors had favored publication in general, although because of strong concerns of some Directors, the pilot project was eventually decided upon. A decision on that day to allow Aruba to publish the Article IV staff report would not be counter to the spirit of that April 5 discussion.

Mr. Chelsky suggested that the matter involved a question of interpretation, not a change in the draft decision. The staff's interpretation was that there may be a conflict between the request of Messrs. Houtman and Wijnholds and the compromise that the Board had reached on April 5. However, the Board was the ultimate interpreter of what went on in the Board; the staff's words were taken under advisement. Aruba's request was believed to fall within the pilot project and there was no conflict and no decision needed, although that was not a view shared by all Directors.

The scientific nature of the pilot project should not be overstated, Mr. Chelsky suggested. The controlled nature of that project was already compromised by the right of any country to withdraw from it. Despite the staff's assurances, there was also an impression that countries could not volunteer to participate in the project at any point in the next 18 months, which further compromised the project.

The pilot project could never fully capture whether the release of a staff report by one country's authorities could change the behavior of another, Mr. Chelsky commented. The pilot study would therefore be impressionistic, not quantitative. Thus, if there was going to be an interpretation of results, the staff could look at the summary of views of what happened during consultations and what came out of reports. That would require judgments. If Aruba was included in the pilot project, the staff could take into account the fact that the consultations had preceded the pilot project and the discussion had occurred afterward. The staff should thus be able to take Aruba into account, knowing full well its circumstances in the context of the pilot project. It was not apparent how that in any way would compromise the validity of the pilot project. There was probably no need for a separate category and no need to exclude Aruba.

The staff had made the point that in the case of Aruba, neither the staff nor the authorities knew at the time of the consultations that the staff report could be published, Mr. Chelsky observed. The only thing that mattered was what the authorities were thinking, and it was clear that the Aruban authorities had shown enormous openness. They had likely been thinking at the time of the consultations that the process would be open. Whether or not the staff was aware that the report would be released publicly was irrelevant, unless the staff was saying that such knowledge would have changed the nature of their consultations. It would be good to hear from the mission chief for Aruba what he or she would have done differently. It was hoped that the answer was nothing.

Aruba should simply be allowed to publish its staff report, which was well within the Board's policy, Mr. Chelsky concluded. If a majority of Directors believed that a decision was required because there was a conflict with the Board's policy, that had not been proven in any substantive way. Mr. Houtman had also pointed out that the majority of Directors at the April 5 meeting had been in favor of allowing the release of the Article IV staff reports.

Mr. Collins said that in the case of Aruba, the discussions had been completed before April 5, but it was not clear whether the paper had been largely written before that date. In what sense could Aruba—if it were fully included in the pilot project without being identified as a special case—contaminate the results? If the experiment was reversed and every country had to publish and Aruba did not want to publish, the consultation would have been conducted under false pretenses. Instead, Aruba wanted to publish its staff report ex post. The Article IV discussions had taken place with Aruba thinking that it would not be allowed to publish, but knowing that it would like to be able to. How would the authorities' approach to those discussions have been different if the discussions had taken place after April 5?

The staff should not have adjusted the method of their consultations if there was going to be more or less transparency, Mr. Collins pointed out. The issue was more whether the authorities would put limits on what they were prepared to tell the staff if there was to be publication.

It was understandable that Directors would prefer not to have any risk of contamination to the sample, Mr. Collins continued. If that meant having a separate subcategory of 24-month consultation cycle countries or that the data on Aruba would not be included within the analysis, that would be acceptable. The first preference was for Aruba to be included among the other countries without any distinction.

The United Kingdom would not use the case of Aruba to reopen its last Article IV consultation, Mr. Collins assured. The country hoped instead to be included in the pilot project in 2000.

The length of the pilot project sample period was 12 months, with another six months for evaluation, during which countries would be allowed to continue voluntarily to publish staff reports, Mr. Collins explained. At the end of that 18-month period, a decision would be taken as to whether to legitimize the program. It would not be appropriate to extend that experimental project beyond 12 months. There would be enough data in that time, with or without the participation of Aruba, to come to what was hoped to be a positive conclusion. The program should not be extended to accommodate a small number of countries. Most of those should instead be included within the sample in some way.

Mr. Rouai observed that the case of the United Kingdom had been similar to that of Aruba, and the Board had refused in that instance to allow any exception.

Mr. Fernández said that to include Aruba in the Article IV pilot project would be totally inconsistent with the process. What was proposed was an adaptation of the rules. No one had in mind the 24-month consultation cycle when the matter had been discussed on April 5. The publication of Article IV reports and the pilot project itself were inadvisable. But as there was a pilot project, it would be fair to authorize Aruba to publish its report separately, as it fell under the 24-month consultation cycle. That provision should apply to other countries in the same situation. It would be best to include the country in the pilot project but exclude it from the evaluation, which was Option B set out by Messrs. Wijnholds and Houtman.

When the Board had discussed the matter of the Article IV pilot project, the staff had proposed both an internal and an external evaluation, Mr. Fernández pointed out. Had the external option been abandoned?

The staff representative from the Policy Development and Review Department responded that the intention was to have the staff conduct a review in 12 months time, with the help of an outside consultant. Thus, the staff did not intend to carry out an external evaluation, but to use outside help to ask and answer the appropriate questions.

The staff's original proposal in March 1999 was to allow for a period of voluntary release of staff reports for any country that so desired, after which time the staff would take stock of what was happening and what lessons had been learned, the staff representative explained. A majority of the Board had been in favor of that proposal, but it was deemed an insufficient majority, because of the concerns raised by Directors. The view expressed by Messrs. Chelsky and Collins was that the release of staff reports would not affect the candor of the dialogue or quality of such reports. However, it was precisely to assess that assumption that the pilot project had been set up. The ad hoc release of reports could make it difficult to test those basic assumptions about the impact of openness on the discussions and the staff report. With such an ad hoc release, the Board could decide to return to the staff's original proposal in March for a period of voluntary release.

The question of whether the staff's or the authorities' behavior would change based on the publication of staff reports raised a complex set of issues, the staff representative added. It was clear from talking to the staff and the authorities that there were a number of different views about that.

Mr. Kpetigo made the following statement:

> I note that the Board reached a careful compromise during the meeting of April 5, where it was agreed that the Board would establish a pilot project that would include countries that wished to participate. For the reasons explained, Aruba was not among the countries chosen. However, we now have an issue where the country wants its staff report published.
>
> I do not think that Aruba wants to be included in the pilot project, but only to make the staff report public. However, to publish it, Aruba needs the consensus of the Board. As noted by Mr. Wijnholds, this would create a precedent and would depart from existing Fund policy. This would appear to be fair, as Aruba would not have the opportunity to publish even its next staff report.
>
> We must find a solution that will satisfy the authorities' wishes.

Mr. Guzman-Calafell made the following statement:

> I do not support the option of allowing Aruba to release its staff report on a stand-alone basis. The objective of the pilot study is precisely to provide safeguards again the potential risks linked to the voluntary release of staff reports. Allowing Aruba to publish its staff report would run counter to the spirit of the compromise that allowed the Board to agree on the implementation of the pilot program.
>
> Furthermore, the stand-alone release of the staff report would set an undesirable precedent, with all of the adverse consequences that that would imply. As explained by the staff, to help ensure a fair sample for the pilot group, it would be appropriate for a member's participation to be limited to those cases in which—during the policy discussions and in the writing of the staff report—there was a clear understanding on the part of the authorities and the staff that the staff report would be released. Agreeing to the release of Article IV staff reports concluded before April 5, 1999 would imply a fundamental risk for the fairness of the sample of the pilot project.
>
> Giving special status to Aruba and other countries in similar circumstances with 24-month consultation cycles is not free of problems, either. I agree with Mr. Donecker about the merits of altering a compromise reached only a few weeks ago. For that reason, my first reaction would be to apply the rules and inform Aruba that participation in the pilot group is not possible.
>
> However, the exclusion of Aruba from the pilot program simply because the Board did not think about countries with 24-hour consultation cycles would not be fair. Therefore, I could support a proposal to create a subcategory within the pilot project to accommodate the release of staff reports for countries on 24-month consultation cycles. That option would inflict the least damage to our agreement in April and to the objectives sought through the pilot program.

Mr. Chelsky pointed out that a significant majority of Directors who had not been in favor of voluntary release of Article IV staff reports, out of consideration for equality of treatment, had now agreed that Aruba and other countries caught in the gap be permitted to release their reports. It was up to the staff to decide how to treat Aruba, based on whether the country should be entirely excluded from the sample or put in a separate category. The Board should not micro-manage the staff's analysis in that way.

Mr. Lehmussaari made the following statement:

> Let me at the outset say that I continue to favor the publication of the Aruba staff report as part of the Pilot Project. This is in line with our position during our previous discussion of this matter. It is also well in line with our generally positive view as regards the trend towards increased transparency.
>
> The staff continues to assert that the Aruba report does not suit the project well. Admittedly, the Aruba report is a borderline case and, further, quite similar borderline cases would most likely arise. However, I prefer to leave it to the evaluators of the project to assess how they eventually will treat these borderline cases. In fact, in contrast to the staff, I would not rule out a priori that a subgroup of similar borderline cases could play a useful role in the evaluation.
>
> As I see it, the stand-alone option is unnecessary, as minor amendments to the Pilot Project would suffice to accommodate the reasonable request from Mr. Wijnholds and Mr. Houtman. As regards the revision of the draft decisions, I would, like Mr. Fernandez, prefer the one suggested by Mr. Wijnholds and Mr. Houtman in Paragraph B in their statement. I also associate my views with the points presented by Mr. Chelsky.

Mr. Cippa fully supported the request of the Aruban authorities, as Aruba could not possibly participate in the pilot project because it was on a 24-month consultation cycle. It was preferable to modify the decision along the lines of Option B suggested by Messrs. Wijnholds and Houtman.

Mr. Karunasena made the following statement:

> We cannot support the present request. However, we are concerned about the difficulties faced by countries on 24-month consultation cycles. Therefore, we request that those countries consider the practical proposal suggested by Mr. Taylor to agree to a 12-month Article IV consultation within the next year.

Mr. Eyzaguirre said that for Directors to undermine the rationale for the pilot project in their efforts to try to make an exception for Aruba was not a way to reach consensus. Given that it was not cost efficient to enlarge the pilot project period or to hold special consultations to shorten the consultation cycle, it was preferable to create a special category within the pilot project to accommodate the countries with 24-month consultation cycles.

Mr. Rouai made the following statement:

> The pilot project constitutes an important and careful compromise. We remain attached to the spirit of the pilot project and we are interested in the learning process it offers. We are therefore opposed at this stage to any amendment of the pilot project and to any stand-alone publication that would compromise the objective behind the project.

Mr. Ogushi considered that the case of Aruba could be included within the pilot project. Discussions between the Fund and the authorities were not only carried out in the form of an Article IV consultation, but as an ongoing process. Following the formal Article IV consultation mission, for example, there was often a second discussion with the staff before the Board discussion took place. There was also a daily discussion through telephone or e-mail messages between the authorities and the Fund staff. In the case of Aruba, it was a risk to put too much emphasis on when the formal Article IV discussion had taken place. It was important to allow Aruba's staff report to be published.

Mr. Newman and Mr. Jonás said that they supported Option B in the statement of Messrs. Houtman and Wijnholds.

Mr. Wei said that he associated himself with Mr. Shaalan's views.

Mr. Donecker asked the Deputy General Counsel to comment on whether amending the draft decision of April 5 would be considered a new decision.

The Deputy General Counsel pointed out that some members of the Board already had slightly different perceptions of the approval in principle of the pilot project. The Board was now deciding whether the category proposed by Mr. Wijnholds could be included in the pilot project. That would not change the decision on transparency. Instead, there would be a decision taken by the Board instructing the staff to proceed with the pilot project as originally agreed, but with that added element.

The Acting Secretary said that there was a clear majority in favor of agreeing to the request of the Aruban authorities to publish its staff report, although there were different views as to whether that should be done as a subcategory of the pilot project or by publishing the report on a stand-alone basis. There appeared to be a plurality in favor of publishing the staff report on a stand-alone basis, although some Directors had said that the staff could decide how the report should be published.

The Acting Chairman pointed out that some Directors were indifferent about the two options, while others clearly preferred one of the two choices.

Mr. Guzman-Calafell stated that the majority was in favor of Option B proposed by Mr. Wijnholds. There was only limited support for the stand-alone publication of the report.

Mr. Fernández agreed with Mr. Guzman-Calafell that the support for Option B was clear, making a specific exception in the pilot project with the subgroup of countries with 24-month consultation cycles.

Mr. Collins asked for a show of hands as to which Directors supported Option B.

The staff representative from the Policy Development and Review Department said that Directors in favor of Option B had suggested that they would like Aruba to be included in the pilot project but perhaps as a special category that would not be evaluated. According to the Deputy General Counsel, under the language proposed by Messrs. Houtman and Wijnholds, the change would not actually require a modification of the draft decision, therefore legal interpretation was not needed. Option B would actually be incorporated into the decision, although how it would be included in the pilot project would be decided by the staff. The stand-alone release of an Article IV staff report would imply modifying the language of the draft decision on transparency.

The Acting Chairman said that Messrs. Wijnholds and Houtman's statement included two options, either making Aruba and other 24-month cycle countries a special case in the pilot study or allowing for stand-alone publication. He clarified that stand-alone publication was Option A and the inclusion of Aruba in the pilot project was Option B.

Mr. Fernández said that his understanding of Option B was that it explicitly said that Aruba's case would not be able to be assessed in the evaluation of the pilot project, which was an extremely important condition for his approval.

The Deputy General Counsel commented that Option B in the statement of Messrs. Wijnholds and Houtman would not require an amendment of the general decision on transparency. The final clause of that option could indicate that cases involving countries on 24-month consultation cycles would be excluded from the evaluation of the pilot project.

The Acting Chairman observed that there was a clear majority in favor of including Aruba in the pilot project as an exception, which would apply to countries with 24-month consultation cycles. Some language was necessary on that. What kind of amendment, if any, was needed?

The Deputy General Counsel said that no amendment was necessary. The Board was deciding that the pilot project should accommodate that category of cases. The option did not only apply to countries with a 24-month consultation cycles, but those for which the staff consultation had already been concluded by April 5, 1999. That would amount to a decision, and the staff would act accordingly.

The Acting Chairman asked whether, if there was a desire to include the U.K. or Italy in the pilot study for the previous staff report, could Option B be applied?

The Deputy General Counsel responded that Option B could not be applied, as those countries had not met the two conditions.

Mr. Chelsky said that he would support whatever option that had the most support.

The Acting Chairman informed that, according to the legal representative's interpretation, the draft decision attached for information would stand.

Mr. Donecker agreed that the text of the draft decision should not be altered. There was an understanding that the 24-month consultation cycle countries would be included in the pilot project but not in the assessment, although the Board had not yet adopted the annexed decision. The Board had decided at the beginning of the discussion that it would not discuss the draft decision text. If that decision was to be discussed, it should be pointed out that there was something missing on page 4. The second sentence read: "The Executive Director of a member wishing to participate in the project will notify the Managing Director." The Board's understanding was that the following phrase should be added to that sentence: "at the beginning of the Article IV consultation," because the point of the exercise was to keep the pilot study clean.

The staff representative from the Policy Development and Review Department said that it was important to be clear about the countries that would be included in the small category of exceptions. Mr. Houtman had mentioned that Option B would include the countries with 24-month consultation cycles for which the staff consultations had taken place before April 5, but for which the staff reports had not been issued and discussed at the Board until after that date. That would therefore not include the four or five 24-month consultation cycle cases that had had both discussions and a staff report discussed by the Board before April 5.

Mr. Eyzaguirre said that the point of Messrs. Houtman and Wijnholds's statement was that the release of the staff report should coincide with the release of the PIN. That would automatically exclude the countries that already held consultations and issued PINs.

The staff representative from the Policy Development and Review Department said that the small group represented by Option B would include Aruba, Iceland—although no request had been made to release its report–Netherlands Antilles, Malta, and Kiribati. However, that would not include another small group of countries for which the staff consultations and Board discussion had concluded in early 1999, and thus would not come back to the Board for almost two years. Hence, those countries, which included St. Lucia, San Marino, Libya, and Samoa, could not be included as part of the pilot project. The staff understood that it was to include the countries under Option B as part of the pilot project but not to incorporate them into the evaluation.

On the broader issue of the implications of the draft decision put before the Board, the staff's understanding was that no modification of the language was required along the lines of Option B, the staff representative observed. It would be sufficiently clear to the staff what was to be in the pilot project, and no exception for stand-alone publication was necessary.

The specific language proposed for the decision would follow the request made by the authorities before the consultation discussions began, the staff representative commented. The staff's interpretation was that if, in the early days of the discussions between the authorities and the staff, it was clear to both parties that the report would be published, and the staff believed that it could measure the effect of that publication, then the staff would include that country in the pilot project. That principle applied to one or two of the cases that had straddled the April 5 decision. If there was such precise language in the draft decision, that could complicate the staff's ability to make judgments. The understanding was clear, however.

Mr. Woolford asked whether the initial decision to release the staff report would be announced by the Fund or remain confidential. That related to the fact that countries could inform the Fund of an intention to release the report but then decline to. Furthermore, why was the Executive Director concerned the candidate in the second sentence of the decision but not in the third? That related to the notification by the Executive Director to the Managing Director, with the extension that the member would directly communicate with the Managing Director. Could the Legal Department comment on whether there was any substantive issue behind that, or was it a wording issue? Was there any difference in the category of eligible exception, compared with the PIN exception? The answer was no and why not, and why not say so? Could the decision cover what was to be done with factual corrections or updates? For example, would the publication of the Article IV staff supplement be regarded as sufficient?

Mr. Collins was concerned about getting into the details of the decision when Directors had not been briefed to talk about it. Directors thought that there would be an opportunity to comment on that decision at a later point.

The Acting Chairman said that any comments on the draft decision should be communicated to the staff representative from the Policy Development and Review Department by the next day, and any suggestions could be incorporated.

The staff representative from the Policy Development and Review Department noted that such feedback would be helpful. There would be an opportunity to discuss any of those decisions when the lapse-of-time decision came into effect, although a few issues could be clarified to help that process. For example, it was not necessary to describe the interpretation in draft decisions. On the confidentiality issue, some authorities expressing the desire to be part of the pilot project had made that fact public. That was their choice. The Board would be informed of those countries that had expressed a desire to be part of the pilot project. The staff did not envisage making such information public. Nonetheless, if a country did express its desire at the outset to be part of the pilot project and thereafter declined, the reasons for backing out would be interesting to the staff's review. That detail would have to be brought back to the Board. The staff would not necessarily publicize that specific case, but the issues and the mention of the specific country would need to come to the Board, as that would be an important part of the assessment.

Regarding the deletion of sensitive material, there was an assumption that the pilot project was equivalent to the PIN process, the staff representative remarked. It was therefore permissible to delete highly market sensitive information from a staff report prior to publication. When staff reports were published, any statement issued by the staff on the day before or the day of the meeting, as well as the PIN, any supplements, and the authorities' response or attempt to state their point of view should also be included. There was no intention, however, to suggest that the staff report represented the last word.

The Deputy General Counsel said that there was no nuance intended in the variation in wording in the draft decision. The concept of the original PIN decision in 1997 was clear: the consent of the member country, normally communicated to the Fund or the Managing Director, controlled the mechanism, not the Executive Director.

The Acting Chairman said that the Board had accepted the formulation proposed by Messrs. Wijnholds and Houtman that those countries on a 24-month cycle that wished to participate in the pilot project but for which the staff consultation had already been concluded by April 5 be allowed to do so, although they would be excluded from the evaluation of the pilot project.

Messrs. Shaalan, Donecker, Al-Turki, Wei, Karunasena, and Rouai said that they could not support the proposed decision, and wanted to be recorded as voting against it.

The Acting Chairman said that he had hoped that the Board would take a unanimous decision, but noted the Directors' objections.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/99/54 (5/21/99) and EBM/99/55 (5/24/99).

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/99/75 (5/20/99) is approved.

APPROVAL: June 4, 2001

SHAILENDRA J. ANJARIA
Secretary