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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/65

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Executive Board Attendance

	E. Aninat, Acting Chairman S. Sugisaki, Acting Chairman	
Executive Directors		Alternate Executive Directors
T.A. Bernes		D. Ondo Mañe
A.G. Carstens		Y. Moussa, Temporary
		J. Nelmes, Temporary
		H. Oyarzábal
		M.J. Fernández, Temporary
		W. Szczuka
		T. Skurzewski, Temporary
		F. Zurbügg, Temporary
		W. Merz, Temporary
		D.H. Kranen, Temporary
		C.-P. Schollmeier, Temporary
A.M. Jul		J.A. Costa, Temporary
R. Faini		G. De Blasio, Temporary
		D. Nardelli, Temporary
K.-T. Hetrakul		S.N. Kioa, Temporary
V. Kelkar		
		S. Zádor, Temporary
		S. Çakir, Temporary
O.-P. Lehmuusaari		A. Fidjestøl, Temporary
		J.M. Abbott, Temporary
		M. Lundsager, Temporary
		E.S. Weisman, Temporary
		G. Bauche
		S. Le Gal, Temporary
A. Mirakhor		
		C. Rustomjee
A.V. Mozhin		
		S. Collins
M. Portugal		
A.S. Shaalan		A.F. Al-Faris
		I.M. Woolford, Temporary
Wei Benhua		Xu J., Temporary
		Y.G. Yakusha
		K. Gobe, Temporary

A.S. Linde, Acting Secretary
J. Prust, Acting Secretary
N. Hairfield, Assistant; S. Soromenho-Ramos, Assistant
R. Gudmundsson, Assistant; S. Djumena, Assistant; and M. Schulte, Assistants

Republic of Estonia—2000 Article IV Consultation; and Review Under Stand-By Arrangement

Staff representatives: Keller, EU2; Abrams, MAE; Kincaid, PDR

Honduras—Enhanced Initiative for Heavily Indebted Poor Countries—Decision Point

Staff representatives: Sorsa, WHD; Seade, PDR

Panama—Stand-By Arrangement

Staff representatives: MacKenzie, WHD; Kincaid, PDR

Republic of Latvia—2000 Article IV Consultation; and Review Under Stand-By Arrangement

Staff representatives: Schiff, EU2, Kincaid, PDR

Also Present

IDB: L. Brachowicz, J. Sapoznikow, C. Sepulveda. IBRD: I. Bannon and H. Lopez, Latin America and the Caribbean Regional Office; H. Boehmer, Europe and Central Asia Regional Office; P. Kyle, Legal Department; L. Promisel, Financial Sector Strategy and Policy Office. European II Department: J. Odling-Smee, Director; G. Bélanger, Deputy Director; P. Keller, V. Kramarenko, J. Mueller, J. Schiff, A. Schimmelpfennig, T. Wolf, B. Zavoico, R. Zytek. External Relations Department: R. Brauning, D. Hawley, K. White. Legal Department: F.P. Gianviti, General Counsel; S.L. Hagan. Middle Eastern Department: P. Alonso-Gamo. Monetary and Exchange Affairs Department: R.K. Abrams, T. Cordella, L. Jacome, M.K. Moore. Policy Development and Review Department: N. Carvalho, G.R. Kincaid, D.N. Kitabire, J. Mongardini, A.A.F. Op de Beke, J. Seade. Secretary's Department: S. Bhatia, P. Gotur, B.A. Sarr. Western Hemisphere Department: C.M. Loser, Director; M.E. Bonangelino, Deputy Director; G. Bindley-Taylor, L.A. Cardemil, A.L. Coronel, M. Gapen, A. Gomez-Oliver, C. Keller, G.A. Mackenzie, V.A. Mercer-Blackman, C.A. Paiva, R.E.M. Randall, R.K. Rennhack, P. Sorsa, J.G. Stotsky, M. Torres. Office of the Managing Director: A. Bauer, S. Tiwari. Advisors to Executive Directors: J.A. Chelsky, B. Couillault, A. Del Cid-Bonilla, I. Dragulin, J.C. Estrella, P.R. Fenton, O.A. Hendrick, O. Himani, E.J.P. Houtman, M.F. Melhem, H. Mori, K. Sakr, G. Schlitzer, I. Steinbuka, T. Turner-Huggins. Assistants to Executive Directors: E. Azoulay, S.A. Bakhache, S. Bonomo, J.G. Borpujari, R. Burgess, I.- K. Cho, V. Dhanpaul, R. Djaafara, T. Elkjaer, E. González-Sánchez, T. Hadded, H. Hagan, M.S. Hililan, S. Hinata, I.C. Ioannou, C. Josz, B. Kelmanson, S.K. Keshava, T.-M. Kudiwu, A. Maciá, J. Mafararikwa, W.C. Mañalac, J.A.K. Munthali, L. Redifer, A.A. Rojas, S. Rouai, C.A.E. Sdravovich, J. Sigurgeirsson, J. Sipko, A. Sutt, D. Taylor, Tong Y., S. Vtyurina, M. Walsh, R.P. Watal, I. Zakharchenkov.

1. REPUBLIC OF ESTONIA—2000 ARTICLE IV CONSULTATION; AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 2000 Article IV consultation with the Republic of Estonia and the first review under the Stand-By Arrangement (EBS/00/101, 6/9/00; and Cor. 1, 6/28/00). They also had before them a statistical appendix (SM/00/118, 6/15/00), a staff paper on issues and prospects with respect to pension reform in the Baltic countries (SM/00/117, 6/16/00), and a paper on saving, investment, and external adjustment in the face of exogenous shocks with respect to the Baltic countries (SM/00/121, 6/16/00; and Cor. 1, 6/21/00), together with background information on the financial system stability assessment for the Republic of Estonia (FO/DIS/00/73, 6/15/00).

The staff representative from the European II Department made the following statement:

Since EBS/00/101 was issued, the authorities have confirmed that they have submitted the new Basic Budget Law to parliament, thereby fulfilling the structural performance criterion for June 30, 2000. Also, the Bank of Estonia has issued regulations for the improved loan assessment framework, including a uniform minimum loan loss provisioning system in line with international standards (a structural benchmark).

While the VAT exemption on thermal energy was lifted effective July 1, 2000, parliament decided to apply the VAT only at a reduced rate of 5 percent instead of the full rate of 18 percent. This will imply a loss of revenue of about EEK 94 million for 2000 (about 0.1 percent of GDP). The government is committed to submit, if necessary, to parliament in August 2000 a supplementary budget with sufficient expenditure cuts to ensure that the fiscal program targets will be met. The authorities have reaffirmed their intention to use any windfalls in revenues resulting from faster than expected economic growth to further reduce the fiscal deficit in 2000.

New balance of payments data show a downward revision of the 1999 current account deficit from 6.1 percent of GDP to 5.8 percent of GDP and a preliminary estimate of the current account deficit for the first quarter of 2000 of about 8 percent of GDP. This outturn is consistent with a current account deficit of 6.5 percent for 2000 as projected in EBS/00/101. The current account deficit in the first quarter of 2000 was financed entirely by non-debt-creating flows—overwhelmingly in the form of foreign direct investment (including a significant amount of reinvested earnings).

Mr. Lehmuusaari made the following statement:

Let me start by thanking the staff on behalf of my Estonian authorities and myself for their dedication and frankness in discussions on the current state of the Estonian economy and the challenges for the period ahead. Their analysis is thorough, the assessment well balanced, and policy advice constructive. My authorities do not have any major disagreement with the staff appraisal. They are of the view that staff gives fair credit to Estonia's commitment to pursue prudent macroeconomic policies, implement structural reforms, and adhere to the best standards of policy transparency.

My authorities also wish to give high marks to the FSAP mission. The authorities found Estonia's participation in the pilot project a most useful experience, both with regard to the general assessment of the financial system, as well to defining the areas of concern. They also see the FSAP/FSSA as a valuable complement to the Fund's surveillance activity.

In addition, we are likewise pleased with the set of background papers discussing the pension reforms as well as saving, investment and external adjustment in the face of exogenous shocks in the Baltics. In the authorities' view, these papers provide a thorough insight into the challenges Estonia and the other Baltic countries are faced with from a medium term perspective. Not least importantly, they also serve, through the cross-country comparisons, the Fund's goal for enhanced regional surveillance.

Notwithstanding the staff's positive assessment, the authorities are well aware of the challenges posed by Estonia's ever growing integration with the global economy and EU accession. Therefore, my Estonian authorities wish to restate their determination to continue with the prudent but ambitious policy course aimed at ensuring long-term sustainable economic growth and being ready for the EU accession by January 1, 2003.

Recent economic data supports the view that the Estonian economy has firmly returned to the growth path and that the recession was short-lived. Following four quarters of contraction, the economy started to revive in the fourth quarter of 1999, driven primarily by the rebound in domestic demand. Further broadening of the recovery in the beginning of 2000 was largely due to the increasingly favorable external conditions—the positive outlook for the global economy and, in particular, strengthening growth in Europe—and Estonia's healthy competitive position. This allowed export volumes to reach their all-time-high as export growth accelerated sharply and reached 47 percent over the previous year in the first quarter of 2000. Although domestic demand was somewhat weaker than expected, exports lifted economic growth to around 5.2 percent in the first quarter of this year.

The latest data also provides further evidence that the two main concerns Directors highlighted during the 1999 Article IV consultation – the high current account deficit and the deteriorating fiscal balance—are fading away. Moderate consumption and lower investment spending, partly explainable by a still existing output gap, resulted in higher domestic savings that contained the current account deficit to approximately 8 percent of the first quarter GDP. Most importantly, the trade and services balance improved markedly and was only 5 percent of GDP. Dividend payments, which were reinvested, accounted for the rest of the current account deficit, reflecting the continued profitability of the FDI and the attractiveness of Estonia's investment climate. As the government maintained strict expenditure controls and the economy revived, the fiscal position recorded welcomed improvement and the deficit narrowed to around 1 percent of the first quarter GDP, or within the program ceilings.

Inflation has remained moderate and the 12-month change in consumer price index stood at 2.9 percent in May 2000. Monetary conditions continue to be supportive for growth. Likewise, the financial sector is well capitalized and liquid to support structural changes in the economy and the new growth cycle. Labor costs in the first quarter grew apparently slower than GDP, thereby compensating in part for last year's excessive wage increases. However, despite the flexibility in the labor market, unemployment has increased somewhat, and stood at nearly 15 percent in the first quarter.

Against this background, the authorities see the near term outlook for Estonia as favorable. They expect the Estonian economy to expand by 4 to 5 percent in the year 2000 and by 5 to 6 percent in 2001, while inflation is expected to remain in the range of 3.8 to 4.5 percent in 2000 and 4 to 4.5 percent in 2001. The moderate underlying current account deficit in the first quarter lays a good foundation for keeping the deficit for the year 2000 below 7 percent. However, the authorities also agree with staff that, as the economic growth gains momentum, investment demand and credit growth are likely to accelerate and current account developments need close monitoring.

My Estonian authorities continue to see the currency board arrangement (CBA) as the most suitable monetary framework for a small open economy such as Estonia. Eight years of experience under the CBA have demonstrated that the CBA has brought substantial nominal and real convergence of the Estonian economy with that of the EU. The CBA has also proved its robustness through the entire business cycle and has readied the economy for the new expansion. Therefore, the authorities continue to believe that, by the time of actual transition to the euro, convergence will have advanced further and the Estonian economy will be able to cope with the increasing competitive pressures of the single market.

The authorities are also of the view that the CBA remains the appropriate framework until Estonia's accession to the EMU. They believe that an orderly adoption of the euro after Estonia has become a full member of the EMU is the best option for the country, as the authorities do not see clear advantages to any alternative strategy. My Estonian authorities are therefore pleased that the ECB has expressed its preliminary position that the accession countries with a sustainable and euro-based CBA might be allowed to participate in the ERM II with a zero fluctuation band, where the CBA serves as a unilateral commitment to augment the discipline within the ERM.

The authorities have launched a comprehensive two-stage review of the operational framework of the monetary policy, aiming at reducing market distortions and achieving full compatibility with the Eurosystem over the medium term. While the CBA remains intact, the reform foresees technical changes in the commercial banks' reserve requirement system. As a most important change in the first stage, banks will be allowed to partially meet the reserve requirement by high quality euro-denominated foreign assets.

The second stage of the reform involves the development of the monetary policy operational framework towards a full convergence with that of the EMU in the medium term. Also, in the second stage, the reserve requirement system will be harmonized with the Eurosystem and intra-day liquidity instruments will be introduced. The second stage will be concluded with Estonia's accession to the EMU, after which, active monetary policy instruments, inter alia open market operations, will be introduced.

The authorities continue their course of fiscal consolidation and streamlining public finances. Fiscal performance in the first half of the year 2000 has been broadly consistent with forecasts, and a deficit ceiling of 1.25 percent of GDP for the year as a whole is well within reach. Should the interim revenue performance turn out to be unsatisfactory, the authorities are committed to submit to the Parliament a negative supplementary budget in August in order to meet the program targets. My authorities are determined to save any windfall gains which may result from a stronger than anticipated economic expansion, bearing in mind the costs of the pension reform and the fact that, under the CBA, fiscal policy is the primary tool for maintaining macroeconomic stability. The government has started the drafting process of the 2001 budget, which aims at achieving a fiscal balance. However, should the economy perform better than underlying projections, the authorities are targeting a surplus for the year to come.

The authorities have also advanced in refining the medium-term framework of fiscal policy. Two issues are central in this respect. First, the government has submitted to the parliament the new draft Budget Law. When passed, the law will enhance fiscal transparency and will bring Estonian budget legislation in line with the EU requirements and with the Fund's code

of good practices on fiscal transparency. Second, the government has approved the main principles of the fiscal strategy for the period 2001-2004. The strategy foresees a lowering of the tax burden; an increase in the quality of public expenditures; speeding up European integration, inter alia via strengthening the administrative capacity of the public sector; and streamlining public debt management. As a result, by 2004, the tax burden should decline to 34 percent of GDP and government expenditures to 34 percent of GDP; Estonia should be ready to join the European Union by 2003; and the public debt is not expected to increase.

My Estonian authorities are in broad agreement with the main conclusions of the FSAP and FSSA reports. This first ever comprehensive assessment of the strengths and vulnerabilities of the Estonian financial sector has supported the authorities in their efforts to set priorities down the road. By now the predominantly foreign financial institutions' owned Estonian financial industry has undergone major consolidation and their corporate governance has significantly improved. Against this background and given the increased integration of the Estonian economy with that of the EU, the staff's conclusion that financial sector vulnerabilities are materially reduced and that the financial supervision is strengthened, save for securities market regulation, did not come as a surprise.

My authorities are particularly satisfied with the input the FSAP exercise produced in preparing for the unification of the presently institutionally separate Banking Supervision, Insurance Inspectorate and Securities Inspectorate. The authorities are convinced that the supervisory reform should result in high and even quality supervision and regulation in all segments of financial markets. However, they also share the view that the introduction of the new unified supervisory authority should not compromise the quality of the banking supervision function, even during the transitional phase. The final decision on the precise modalities of unification, notably on the legal form, will be taken in immediate future.

The authorities agree with the staff that, given the banks' ample capitalization and liquidity, credit developments need a close monitoring. While they also agree that the use of the moral suasion in influencing banks' behavior is one of the policy options, they also see a role for other regulatory measures for this purpose.

My authorities continue to give due consideration to structural issues, which, if not properly addressed, might pose a serious threat to fiscal sustainability, and to the economy's long-term growth potential. Therefore the overhaul of the current pay-as-you-go (PAYG) pension system, health care and education framework, as well as the strengthening of public administration, are on the top of the authorities' reform agenda.

With respect to the pension reform, the authorities have yet to decide the key issues of financing the transition costs and the eligibility criteria for joining the fully funded mandatory pillar. While specifics are still open, the authorities do not see debt financing as a viable option, nor do they envisage any capital controls on the investments of pension funds. In this debate, the authorities value the quality over the speed of the decision. Therefore they expect the implementation of the fully funded mandatory pillar to take place as of 2002.

Regarding the labor market, the authorities are of the view that labor market development and flexibility deserve continuous attention, particularly bearing in mind the upcoming EU accession. Although the labor market has exhibited considerable flexibility, allowing the real and, in certain cases, also the nominal wages to decline, the current framework of wage formation, social guarantees and vocational training are at the heart of the agenda.

My Estonian authorities are also of the view that the current high unemployment level should not be seen as a "hardship" imposed by the CBA. Rather it is a reflection of economic restructuring during the transition phase, and of the business-friendly legal framework that allows lay-offs as a necessary part of economic restructuring. In particular, the recent recession has forced companies to increase their efficiency, as the pre-crisis output levels have been reached with lower employment. Therefore the authorities consider the improvement of vocational training and retraining, as well as the reform of the educational system, while maintaining a business-friendly legal framework, as primary policy tools for reducing the unemployment level and ensuring labor market flexibility, labor mobility and competitiveness. In this connection, they also emphasize that labor market measures will have a considerable time lag before their full effect is seen, and therefore the unemployment is expected to remain elevated in the near-term.

The authorities have also advanced with the privatization agenda. The government has approved the sale of a 49 percent holding in Estonia's main power generation company to the US energy firm NRG Energy. Privatization of the railway company is proceeding according to schedule, and the Bank of Estonia is closing the sale of its majority holding in Optiva Bank to the Finnish financial conglomerate.

Finally, my Estonian authorities wish to restate their commitment to the highest standards of transparency. To this end, the authorities continue to participate in the pilot project of the publication of Article IV staff reports. They also intend to publish the financial sector ROSC binder. Although understanding the reservations that some countries have regarding the publication of the FSSA report itself, they regret that this is currently not possible on a voluntary basis. The assessment of compliance with the Code of Good Practices in Fiscal Policies is currently underway.

Mr. Mozhin and Ms. Vtyurina made the following statement:

We welcome the continuation of encouraging macroeconomic developments in Estonia as well as the progress achieved in the implementation of the program under the precautionary SBA. In early 2000 the GDP growth resumed, exports to western markets accelerated sharply, current account deficit was significantly down, and very positive developments took place in the fiscal area. In addition, financial sector vulnerabilities have been significantly reduced, and after the completion of the FSAP there should be further progress expected in this area. In this regard, we thank the staff for the FSAP paper which presents a thorough overview of the Estonian financial system and which should serve as an excellent guide for future improvements.

Since the last review was only a few months ago, we will limit ourselves to a few observations.

We commend the authorities for significantly reducing the fiscal deficit in the second half of 1999, which, in part, was a result of the passage of the supplementary budget. If the strong commitment of the authorities to stick to the program spending targets persists, it seems that this year's fiscal deficit target is also achievable. Taking into account that a more comprehensive analysis of the 2001 budget will be made at the second review, at this point we just want to join the staff in their advice to secure expenditure cuts before going ahead with the array of proposed tax cuts. It is important to keep in perspective that the reduction in the fiscal deficit in 1999 was made possible due to expenditure cuts under the supplementary budget as well as due to the deferral of some expenditures, amounting to 0.6 percent of GDP. Considering the goal of achieving a fiscal balance next year, it is important that the authorities further reduce budget deficit on the basis of additional revenues rather than continuously resorting to spending cuts.

A great part of today's papers were devoted to the pension reform in Estonia. The present PAYG system may become unsustainable when faced with the demands of changing demographics. This is on the agenda of many transition economies. However, only few of the countries have already adopted fully-funded (FF) systems. With all the advantages, however, many caveats, such as a significant budget costs, the burden on transition generations, political resistance to the increase in the retirement age and the need to rely on the underdeveloped domestic capital markets, still remain to be addressed. Estonia, in its turn, is rather actively considering the implementation of the FF system. The major concern of both the authorities and the staff seems to be the potential consequences to the budget. If the authorities aim at a balanced fiscal position, debt financing of the pension reform, especially external financing, rightly is not seen as a viable option. Therefore, the authorities will probably have to rely on the privatization

revenues as well as possible future fiscal surpluses when seeking financing alternatives for the pension reform; and we encourage them to fully exhaust these options.

The BoE has been successful in establishing a well functioning and prudent financial system. Estonian banks enjoy good credit ratings and are able to replenish their liquidity by borrowing externally without restrictions. As the results of the FSAP disclose, the health of the banking system has markedly improved, to a great extent due to the process of restructuring and consolidation that have taken place over the past several years. The improvements in regulation and supervision have added to the stability of the system. Of course, work continues to be in progress and further improvements are warranted. In this regard, we welcome the recently issued regulations for the improved loan assessment framework. More progress is also necessary in non-bank financial supervision, particularly in the area of securities supervision; and we are content that the authorities seem to be on top of the agenda in this area.

Given such a healthy state of banks and the economy in general, one would expect that the rate of credit growth to the private sector would be recovering at a much faster rate than at present. Credit growth dropped dramatically from 76 and 40 percent in 1997 and 1998, respectively, to 2.5 percent in 1999 and is currently averaging 9 percent. These developments are similar to the credit growth pattern in neighboring Latvia in 1997-98. Both countries at that time were going through a period of very favorable economic circumstances and enjoyed access to foreign borrowing which led to a significant credit expansion. Later both had been affected by the Russian crisis. However, it seems that the growth of credit in Estonia should be rebounding at a much faster pace given the nature of the exchange rate arrangement, current historically low interest rates, a much stronger banking system and less dependence on trade with Russia (the paper *The Baltics – Savings, Investment, and External Adjustment in the face of Exogenous Shocks* sites these reasons as well when acknowledging that Estonia was faced with the most moderate external shock). Nonetheless, in Latvia the credit growth under the program is expected to be at around 25 percent which is much higher than that in Estonia. For the economy to grow at the rate of 4-6 percent, it seems that a higher credit expansion may be warranted. From the staff paper as well as from Mr. Lehmussaari's statement, however, it seems that actually the authorities are worried about a too rapid credit expansion and are ready to use moral suasion to prevent this from happening. In this regard, we would be very interested in the staff assessment of the situation.

It is also interesting to note that credit to households has been growing at a much faster pace than credit to the enterprise sector. It is unlikely that companies are raising significant funds through the equity market since the capitalization of the market is still very low. There is also no functioning

corporate bond market. The last year's Article IV papers suggest that, in addition to other consequences of the Russian crisis, the banks became more cautious in their lending due to the losses from the stock and loan portfolios and a general slowdown of the economy. It is our impression that the enterprise sector is experiencing rather tight financing conditions which may be hindering its restructuring and development. Staff comments would be appreciated.

In conclusion, we wish the Estonian authorities further success with challenges ahead.

Mr. Mori made the following statement:

We wish to thank the staff for the informative and well-written report on Estonia. We also appreciate the Financial System Stability Assessment report on Estonia and the excellent papers on Saving-Investment and Pension Reform in the Baltics.

We are pleased to note that the Estonian economy continues to improve, and the recent data indicate that growth has strengthened further this year. As the economies of Estonia's major trading partners are narrowing much rapidly their output gap, one could expect a good prospect for exports as an engine for growth in Estonia. In addition, the continued flow of foreign direct investment will allow the appropriate stimulus for domestic demand and enhanced productivity capacity. We see, therefore, good prospects for Estonia to follow a path of high and sustainable economic growth.

Still, we single out two challenges for the authorities in the process; namely, the allocational problem of the gains resulting from the economic development among all groups of society where a substantive skill mismatch exists, and the management of domestic demand in view of the limited instruments available for this objective in a context of a currency board system.

One concern of difficult solution is the prospect that the current structural rigidities in Estonia could lead to an unequal income growth. This trend seems already to be reflected in the high unemployment, beyond the cyclical factors, as a result of the restructuring of the economy in combination with a mismatch of skills both for older workers and labor market entrants. With economic development, as investments mature and new technology is incorporated, the trend is for productivity to increase considerably. But these new sectors with higher potential for growth tend to employ a smaller number of workers. There may be a possibility for the expanding service sector to absorb additional workers; but the staff notes that certain rigidities would make difficult the absorption of displaced workers from shrinking sectors of the economy. As noted in Mr. Lehmuusaari's statement, an appropriate public

policy—including the improvement of vocational training and retraining, as well as the reform of the educational system—addresses in part the problem of adapting the labor force to the requirements of the newly emerging economic structure. But it is a complex issue to frame an optimal policy that would redistribute the gains of most productive sectors where the income tends to be higher for the benefit of the economy as a whole.

On demand management, under a currency board arrangement, fiscal policy remains a key macroeconomic policy tool. A very conservative fiscal policy needs to be pursued to avoid overheating of the economy—for instance, by cutting taxes as the required expenditure cuts are firmly in place and by using excess revenues resulting from unexpectedly high rates of economic growth for moving towards a smaller budget deficit. But given its rigidities and the lag necessary to produce an impact on the economy, fiscal policy alone may turn to be a restricted instrument for demand management. Demand pressure in terms of easy external credit conditions, as observed recently, appears to be less likely, but exports and investments may also stimulate domestic demand in excess of the supply capacity of the economy.

Even with less favorable external credit conditions, as banks may access foreign financing, one should be cautious and monitor closely developments in domestic credit to detect early on any tendency toward credit expansion that could stimulate further the economy. We agree with the staff's view that prudential policies are key to break an excessive expansion in domestic credit, including to resort to higher reserve requirements. We also agree that the BoE should be prepared to intervene directly in the management of the largest banks if, in its judgment, the pace of lending were to become inconsistent with prudent banking.

Under a currency board, a banking system where foreign banks have a majority shareholding can ensure financial stability. This is so especially considering that they have easier access to international interbank market, as well as access to the rediscount window of a lender-of-last resort if the headquarters of these banks are established in a reserve currency country. Still, foreign banks may be optimizing in terms of a global or their headquarters' perspective, which sometimes happens to be unrelated to the interest of the host economy. In such a context, there may occur a situation in which foreign banks operate pro-cyclically by providing abundant credit to the host country in its economic expansion cycle, and contracting abruptly their exposure as perception of risk heightens.

On pension reform, we are puzzled by the authorities' intention to invest outside Estonia the bulk of the funds in the second pillar. If the savings-investment balance remains at the current level with a continued need of net external borrowing, in a currency board framework, any resources sent abroad will require as a counterpart an inflow of capital. This means domestic firms

need to borrow abroad to compensate the investment of pension funds in foreign assets. There could arise a situation in which the cost of borrowing for domestic firms would be higher than the return for investments abroad. The staff, therefore, are right in cautioning against vulnerabilities that may arise with the need to rely largely on foreign financing to offset expected foreign investments under the second pillar.

The staff prepared an interesting comparative study on saving, investment, and external adjustment in the Baltics. This study will allow us to understand better the macroeconomic dynamics—and the role of country's economic structure—observed in recent episodes of the boom-bust process not only in the Baltics but also in countries in other regions. It suggests that, in Estonia, because of its economic specificities, the current account is negatively correlated with real domestic credit creation and the fiscal balance. A domestic credit expansion fed by capital inflows might have accelerated GDP growth through expansion in private consumption which in turn allowed an improvement in the fiscal balance with the increase in revenues while led to a deterioration of the current account as imports increased. Indeed, the current account deficit declined to 6 percent of GDP in 1999 after widening significantly to 12 percent of GDP in 1997. The budget balance deteriorated to a large deficit of 4.7 percent of GDP in 1999, compared to a surplus of 2.2 percent of GDP in 1997.

Such a path was also observed in other economies in the recent period of expansion and contraction in international liquidity. One difficulty is to distinguish between external and domestic factors as the cause of, first, an excessive expansion of GDP growth and, then, a sharp contraction. From Table 19 on interest rates, page 22, of the Statistical Appendix, one can see that lending and deposit rates in Estonia remained below inflation (Table 5, page 8, of the Statistical Appendix) in the period 1994-96—in fact this trend was observed until the international capital turmoil in the fourth quarter of 1997. There might be a significant external component which led to an over-lending perhaps with some market imperfections contributing to the excessive expansion of credit, or even simply easy monetary policy conditions in the major financial centers.

Mrs. Zador made the following statement:

Estonia is generally a good performer. Its currency board regime (CBA) has succeeded in rapidly bringing down inflation and thereby stimulating economic growth. After the brief banking crisis of 1997-1998, interest rates have been converging toward the anchor currency's level, and economic recovery quickly resumed. And despite the difficulties of the crisis period, the CBA has remained strong and has achieved remarkable credibility.

The interesting background papers give useful insights into special features of the Estonian case, such as the strong relationship between the current account and the private savings/investment balance, the behavior of the real exchange rate, the sources of competitiveness, and the role played by microeconomic structure (i.e., foreign ownership) in strengthening the economy's resilience. The most remarkable of these features is the private sectors' strong responsiveness to changes in demand. The economy reacted to the external shock of the Russian crisis with a sizeable contraction of private investment and domestic credit, automatically improving the savings/investment balance. But now, with a "V" shaped recovery under way, the strong growth of domestic credit and private investments is again the main contributor to the deterioration of the savings/investment balance.

The remarkable flexibility of Estonia's production factors (labor, investment) makes the currency board strong and effective. But it leaves the authorities few policy tools capable of smoothing out this variability. Even public sector financing, the principal means of correction, has little effect. Under these circumstances, the social costs of the large swings in the real sector are not negligible.

Since I generally agree with the staff's appraisal and the program targets, I will only comment on a few issues.

Both staff and the authorities are less worried this year than last about the balance of payment, since the first quarter deficit to GDP ratio of 8 percent does not seem to threaten the annual target of a deficit to GDP ratio of 6.5 percent. Competitiveness seems healthy and the structure of its deficit financing broadly safe. The only weakness in the first quarter performance is that both exports and imports surged. Imports increased partly because wage increases pushed up consumer demand. This means that the current account deficit could keep growing as fast as in the first quarter as the recovery continues.

The current account deficits of transition economies are structurally high, and mostly investment driven. The authorities commitment to a tight budget is reassuring. But investors do not always distinguish between good and bad current account deficits, and any sudden change in investor confidence would put pressure on the currency. Here I share the cautious assessment of the FSAP report that although this is not a short-term risk, the longer the wait for EU accession the greater the risk to the currency board arrangement, since investor expectations would be disappointed. I hope that Estonia's intention of being ready for EU accession by January 2003 will not be frustrated by uncertainties and long delays on the part of the European Union.

On monetary policy, I noted that Estonia has abandoned the idea of an early adoption of the euro. I would like to learn the staff's thinking on the matter, since some Fund studies (e.g. "Exchange Rate Regimes in Selected Advanced Transition Economies" from the EU1 Department) explicitly suggested that this would be a way for Estonia to achieve convergence. What are the main arguments against the idea?

I also noted that the authorities plan some "technical" changes in the system of reserve requirements for commercial banks that would allow them to satisfy part of their reserve requirements with high-quality euro-denominated foreign assets. But the impact of such changes is not clearly explained. If I am not mistaken, in practice this "technical" step would result in reducing the effective reserve requirement. Although the measure would improve the competitiveness of the banking sector and bring effective rates closer to EU levels, it also would increase liquidity at a moment when monetary conditions are already accommodative and domestic credit is growing. I see some inconsistency with the staff's suggestion that "Estonia might need to resort to higher reserve requirements to brake an excessive expansion in domestic credit."

Finally, I wish to comment on Estonian unemployment, which jumped to 15 percent in the first quarter of 2000. Though the authorities are right to say that layoffs are a necessary part of economic restructuring, this question still deserves our full attention. The very flexible nature of domestic investments in Estonia could cause large swings in employment figures far beyond any structural explanation. Not even the highly flexible wage structure that allows nominal wages to decrease has been able to prevent a rise in unemployment. And though the present jump is viewed as "temporary," policy makers should be aware of the risk of tensions building up over time. High and stagnant unemployment could erode public support for the whole accession process.

With these remarks, I support the proposed decision and wish much success for the authorities.

Mr. Skurzewski made the following statement:

I welcome Estonia's return to growth and low inflation path under the precautionary Stand-by Arrangement. As I generally share the views of the staff, I will limit myself to just a few remarks.

The current account deficit is still at an uncomfortable level, but it does not constitute a key problem as long as it is financed by foreign direct investments and other non-debt inflows. However, it certainly requires the continued attention of the authorities, especially in view of the foreign trade

data for the first quarter of 2000. The ambitious plan for decreasing and ultimately eliminating the fiscal deficit is one of the factors in favor of this.

Fiscal policy is the main macroeconomic policy instrument available in an economy with a currency board regime. Estonia has introduced a unique flat income tax and is pursuing the goal of a further move from direct to indirect taxes, with a decreasing tax burden in general. I wonder if the staff is in a position to say something more about the budgetary impact of the taxation changes introduced in January 2000 and whether the actual outcome of tax revenue for the first quarter is still in line with the estimates included in the request for a Stand-By Arrangement report. The authorities' willingness to introduce expenditure cuts, if needed, in addition to those that took place last year, is positive.

I also welcome the progress on pension reform. Like Mr. Mozhin and Ms. Vtyurina, I think it should be financed without too much of a burden on the budget, and support the idea of using the stabilization reserve fund for that purpose. I concur with the staff that the introduction of a fully-funded second pillar will provide some effects in the longer term, while short-term remedies should include an increase in the retirement age and change in the pension cost of living adjustment rules. Looking at the issue raised by the staff and Mr. Mori of investing resources collected by new private pension funds, I tend to support the authorities, who are thinking about allowing the bulk of such investments to be made abroad. In light of the capital market's limited or even nonexistent domestic fixed income securities, the low capitalization of the stock market, and the planned merger with the Scandinavian exchanges, the choice is a good one.

With all of the performance criteria and benchmarks observed, I support the proposed decision and wish the authorities further success.

Mr. Nardelli made the following statement:

We are pleased by the economic developments in Estonia. Under the Stand-By Agreement, the authorities have maintained their commitment to sound macroeconomic policies and structural reform. Confidence in the currency board continues to be strong, and the Estonian economy has proved resilient to the Russian crisis, also thanks to its ability to increase trading with different partners to compensate for the contraction of the CIS market. Being largely in agreement with the staff's appraisal, we support the completion of the review and will confine our remarks to a few points, namely labor market conditions, problems in the pension system, and financial market issues.

The level of unemployment is already high, and with part of that amount becoming of a structural nature, this problem might emerge as a key policy issue in the near future. The growing skills mismatch is a matter of

concern, given that the Estonian economy is open and there are substantial FDIs, which, in turn, should create many opportunities for Estonian workers. We find it worrisome that, as shown in Table 8 of the statistical appendix, total employment in the first half of 1999 actually dropped by 4 percent compared with 1998, despite an increase of 0.5 percent in public administration employment. If the educational system is not able to provide the necessary level of professional skills required in the market, only a limited part of the national work force will be in a position to benefit from the growing number of job openings. Moreover, this might affect the country's external competitiveness by putting upward pressure on wages.

We note that nominal unit labor costs started to increase in 1999, together with the marked increase in the level of unemployment. We therefore urge the authorities to put labor market policies among their highest priorities and to concentrate on the elements listed in Box 5 of the staff report, particularly on the reform of the education system.

Turning to pensions, the pay-as-you-go system might come under considerable strain in the years ahead as a result of unfavorable demographic trends. The authorities have promptly reacted by initiating an effort to integrate the current system with a fully funded contribution scheme. We note the initial difficulties of such an approach, especially during the transition period from one system to another, and encourage the authorities to move ahead with their plan.

We have some difficulty understanding the authorities' reluctance to have the fully funded pillars invest widely in government debt and other domestic instruments. While we agree that such investment should not be mandatory, the launch of domestic funds for the management of retirement assets could represent an opportunity to develop the domestic financial market, which at the moment lacks depth and liquidity. Moreover, we do not find the argument about the diversification of investments compelling. Some of the largest companies traded on the domestic stock market are controlled by foreign groups, and it is likely that more state-owned companies will come under foreign control as privatization continues.

We welcome the progress made by privatizing the remaining state-owned banks and the numerous improvements in banking supervision and accounting practices, as pointed out in the Financial Sector Stability Assessment (FSSA). However, some issues remain open. The first issue is the trade-off between concentration and competition in the banking market. While a certain degree of concentration is necessary in order for banks to operate efficiently, given the size of the Estonian market, having the two largest banks control 85 percent of total assets is probably not optimal for fair competition, as evidenced by the recent staff assessment. Unifying the functions of several different offices into one single body is appropriate, in light of the market

size. However, it will be critical for the new body to be empowered along the lines recommended by the staff in order for it to discharge its duties in an effective manner.

Let me praise the decision of the staff not to include the privatization proceeds in the medium-term projections, owing to their uncertainty. This decision will contribute to maintaining sound fiscal balance, as it could be used to offset potential negative impacts on the public debt arising from the worse than expected dynamics of the pension deficit.

Mr. Borpujari made the following statement:

I had only two points and they have already been touched upon by other Directors and explained in the eloquent statement from Mr. Mori. First, the issue of unemployment, as the authorities have pointed out, is not a problem that is going to go away in the near future; indeed, it is going to grow. Therefore, the problem of skills mismatch has to be addressed in a more productive manner by reforms of the education system.

The other issue is that of the pension system. There is obviously reason to hope for early action here, because the staff report makes clear that it is a matter of active debate in the country. I also support the authorities' intent to look for security of pension funds. However, that said, I do share the concerns that Mr. Mori emphasized, because this does raise issues that have to be kept in mind.

Before concluding, I thank the staff for a well written and insightful staff report.

Mr. Yakusha made the following statement:

Estonia's economy is undoubtedly one of the most successful transition economies. This is confirmed not only by the country's impressive macroeconomic results before the Russian crisis, but, more importantly, by the economy's ability to withstand that crisis with minimal adverse effects. Exports have grown quite impressively, and inflation has continued to fall to low levels. These developments are attributed to the authorities' continued skillful and responsible macroeconomic policy, consistent with broad and steady support for prudent fiscal and monetary management and combined with extensive, market-based economic reforms in the second half of 1999. This was once again demonstrated by the introduction of a supplementary budget, which has reversed the deteriorating fiscal situation and put the country on a path toward a balanced budget in 2001.

Over the medium term, this policy has generated high economic growth. The fact that the private sector represents 70 percent of GDP is

comforting in a much better diversified economy, which is among the largest per capita recipients of FDI among all transition economies. We encourage the authorities to continue on this path of policy implementation, and share the view mentioned in Mr. Lehmussaari's helpful statement that Estonia's outlook is favorable. I would like to mention only some points for emphasis.

As the staff pointed out, fiscal management is most important in a currency board arrangement, and the kind of fiscal discipline that has characterized Estonia in recent years, together with the enhanced privatization process, have benefited the country with relatively low levels of government and external debt burdens. This low debt burden has played a major role in protecting the economy against contagion from the Russian crisis.

It is important to be cautious, however. First, there is not much left to be privatized. Second, despite the low overall level and burden of debt, the authorities continue to largely rely on short-term debt. That is why we urge them to continue to restrain fiscal policy, which should facilitate a shift to longer term financing and reduce the country's rollover risk.

On pension reform, we share the view that establishing a fully funded second pillar might be covered not only by the current budget. We would like to know to what extent the authorities intend to use funds circulated in the stabilization reserve fund for those purposes.

Maintaining Estonia's currency board arrangement could be critical to the country's accession to the EU, by ensuring low inflation and promoting credibility. If tighter budgetary discipline is not considered sufficient, we agree with the staff's advice and would urge the authorities to opt for more stringent liquidity requirements. They should probably also more aggressively use banking supervision tools in order to ensure that banks do not relax their internal risk management procedures. I would like to commend the authorities for their participation in the FSAP. More importantly, the health of the banks and the banking system is encouraging. Like other Directors, we share the staff's opinion that a new, unified supervisory body is important, but it has to have adequate budgetary and legislative power in order to ensure compliance.

Like others, we are concerned about the substantial increase in Estonia's unemployment rate, and wonder if perhaps the staff could provide additional comments about the major factors behind it. We also have taken note that Estonia offers minimal and basic unemployment benefits, and feel that this might discourage registration for the unemployed. We would like the staff's views as to whether the official data accurately reflects that phenomenon. We would also be interested in additional comments on the geographic distribution of unemployment throughout the country.

Mr. Mirakhor made the following statement:

We thank the staff for the well-written reports on Estonia and the Baltics. Four months have passed since the last discussion on Estonia, and almost all economic indicators seem to be moving in the right direction. The program is on track and the real economic growth has resumed, inflation has dropped to low levels. We commend the authorities for their skillful management of the economy, paving the way for a sound and successful accession to the EU. We concur with the staff's analysis and policy recommendations and wish to make only a few comments.

First, to reach the 2000 fiscal target and achieve an overall balance, an exercise of firm fiscal discipline is necessary. We agree with the staff that any decision on tax cuts has to be preceded by expenditure cuts.

Second, the reduction in vulnerabilities of the financial sector is commendable, as summarized in Box 3 of the FSSA report. More should be done to address the problems in the securities supervision. We share the staff's view that introduction of a unified financial supervision should not compromise the high standard supervision in the banking system. The sharp increase in stock market prices in one quarter could be indication of the resumption of economic growth. While the current levels are still below their mid-1997 peak, staff's comment on the likelihood of stock market correction and its quantitative impact on economic growth is welcome.

Third, the unemployment rate (ILO definition) in Estonia is not high by European standards, the rising trend of this variable is reason for concern. While the economic restructuring is the main cause of unemployment, staff may wish to elaborate on how much of this unemployment is structural. More active labor market policies should be pursued to reduce unemployment.

Fourth, regarding the introduction of second pillar of the planned pension reform, we share the authorities' view that debt financing of the reform is not a good option and that other ways have to be sought to address this issue. In this respect, restricting the eligibility criteria could address this issue. In this respect, restricting the eligibility criteria could be a good option that deserves to be reconsidered. Investing the resources accrued from the second pillar outside Estonia could expose the pension system to risks of volatile international financial markets.

Fifth, the nexus between the saving-investment balance, high current account deficit, domestic credit growth, and the currency board requires continuous vigilance; and external borrowing needs close monitoring.

With these remarks, we support the completion of the review and wish the authorities further success in managing the economy.

Mr. Xu made the following statement:

I am grateful to staff for the set of comprehensive reports and also to Mr. Lehmussaari for his helpful statement. I am pleased with Estonia's economic performance since the last Article IV consultation in 1999, in particular, it is encouraging to realize that, as highlighted by Mr. Lehmussaari, the high current account deficit and the deteriorating fiscal balance are fading away. For the Fund program in particular, all the performance criteria under the SBA were met as of end-March 2000 and the structural performance criterion for June 30, i.e., submission of the new Basic Budget Law to the parliament was completed. Mr. Chairman, since I agree with the thrust of the staff appraisal and support the proposed decision, I would like to make two remarks on fiscal policy and the unemployment issue for emphasis.

First, on fiscal policy, I fully associate myself with the staff and Mr. Lehmussaari. In particular, though the pension reform is unlikely to have any impact on the budget during the program period, it is important not to underestimate the cost of the pension reform, which might create pressure on the budget in the medium term. Moreover, I concur with staff on the issue of the proposed tax cuts that any tax cut needs to be matched by the same scale expenditure reduction so as to keep the budget within the program ceiling. Overall, I am reassured by the authorities' demonstrated efforts to target a surplus for the year to come.

Second, on the issue of unemployment, I share the staff and other speakers' concerns, particularly, the long-term component of the relatively high unemployment. As observed by staff, the return to growth has not led to a reduction in unemployment, at least up to now. Staff elaboration is welcome. What is the staff view on Estonia's medium-term employment prospects?

Mr. Chairman, in conclusion, I fully support the completion of the first review of the Stand-By Arrangement and wish the authorities continued success.

Mr. Kioa made the following statement:

The set of staff papers and the statement from Mr. Lehmussaari are both comprehensive and forthright. We also commend the authorities in meeting all the performance criteria under its precautionary SBA at end March 2000 and more so to their skillful efforts to resume economic growth, reduce fiscal deficit and keep inflation at low levels.

Despite these satisfactory performances, there are certain challenges remain. The uncertainty in the external balance does impose some conditions on the future direction of fiscal policies. The contraction in the exports to the

CIS markets has yet to recover and the likely increase in imports due to the economic recovery and the import impact of the upcoming electronics sector would leave insecurity in the external balance. And like the staff appraisal, a tightening of fiscal policy would be needed if external position deteriorates.

Secondly, high unemployment rate is a major social and fiscal concern. The mismatch of skills of displaced workers and labor market entrants alike must have caused unemployment to remain high. The authorities would therefore need more active emphasis on vocational and technical training and trying to match the industry needs and available skills. Furthermore, I notice that the statistics from the manufacturing sector do reflect some increasing reliance on capital intensive industries. Total manufacturing output increased significantly since 1995, in line with the increase in returns to labor, but the total employed have decreased considerably. To absorb the excess labor the authorities might find it useful to push further for more diversified industrial activities.

With these remarks, we support the proposed decision and wish the authorities success in meeting its future challenges.

Mr. Le Gal made the following statement:

Since the Board's last discussion on Estonia, the situation did not change, which is for the best, as Mr. Mirakhor just said. Growth prospects are good and the recovery has been export-led, which has eased any concerns that we could have had in this area. As I am in agreement with the staff appraisal, I would just make a comment about the currency board and its future regarding the participation in ERM II.

As the Estonian economy demonstrated in 1999, a currency board is demanding for the real economy. While the currency board has served Estonia well, further reflection on the best transition mechanism to the ERM II, and later the EMU, is important. Indeed, the ECOFIN will deepen its work on this issue in the forthcoming months and define a strategy to ensure the best adaptation of ERM II to the various exchange rate regimes in EU candidate countries.

With these remarks, I support the proposed decision.

Mr. Costa made the following statement:

Estonia has been the leading country among the Baltics in the process of transition to a market economy. The fact that this has been achieved within a Currency Board framework makes the Estonian case an interesting one to compare with other types of exchange rate arrangements. To be sure the Currency Board has been strengthened by a full-fledged process of structural

reforms particularly through the establishment of a modern legal framework and privatizations of public enterprises with participation of foreign investors who undertook an effective restructuring, introduced modern technology and improved corporate governance. There is ground to believe that while structural reforms are indeed critical to support a Currency Board Arrangement (CBA), the latter can also be presented as an important factor to unleash the process of structural reforms, including flexible labor and product markets, so critical to increase productivity and maintain external competitiveness within that framework.

The recent Estonian experience during the Russian crisis highlights other features of the CBA. While growth rates were generally higher than in other Baltic countries before the crisis, at the time of the correction in the first half of 1998 the deceleration in real GDP growth was more pronounced. Yet the rebounding was also faster. The greater role of the private sector in the adjustment process within a CBA is also revealed by the Estonian experience, where changes in both private investment and private consumption were more pronounced in Estonia than in the other two Baltic countries. An important aspect of the recent growth in private demand in Estonia is the sharp increase of exports to western markets, including through the expansion of electronics exports in the wake of a marked influx of foreign investment in that sector. Also remarkable is the increase in real services exports such as tourism.

In the fiscal front, we welcome the better than programmed performance during the first quarter with a general government deficit of only 1 percent of same period GDP vis-à-vis the 2.3 percent established as the program target. The latter augurs well for the achievement of the targeted balanced budget for 2001. The ambitious proposal of achieving this in a scenario of tax cuts would provide, if implemented, a strong boost to the credibility and potential of the Estonian economy, since it would require a reduction of the relatively high expenditure to GDP ratio in 3 percentage points of GDP, reaching the 39 percent level in 2001. In this context it appears as a matter of concern that public sector wages increased by over 20 percent in real terms during 1999, even when private wages in sectors more affected by the Russian crisis declined in nominal terms. I would appreciate staff comments on this development which in the present environment of high unemployment may draw people towards public employment making the reduction of public expenditures more difficult.

The very low level of public sector debt and the willingness of the authorities to keep that level low gives, however, ample reassurances that the fiscal front will not create any major difficulties in the foreseeable future. It is intended in this regard that the fiscal cost of the planned pension reform is not financed by domestic debt sources but by privatizations proceeds. The expected freedom to invest the resources channeled to the fully funded second pillar in foreign assets is an additional reassurance that an excessive building

up of domestic financing will be avoided. The impairment that the latter may entail to the domestic capital market may not be that significant particularly when Estonia is very well positioned to become a member of the European Union in a not so distant future.

On the monetary area we support the authorities' decision to maintain the CAB until the euro becomes Estonia's official currency which has been facilitated by the recent decision of the ECB to accept euro-based currency boards under ERM2. Staff appears concerned with the risk of an excessive growth of credit and broad money and with the limitations of the BoE to effectively control those aggregates and it even suggests the need to take recourse to moral suasion. In our view, a sound supervisory and regulatory environment should be enough to avoid any risk of imprudent lending. Moreover, we share the view of the authorities that reserve requirements should be seen primarily as a prudential mechanism and not as a policy instrument as staff seems to suggest in the appraisal. The BoE's decision to allow banks to meet a growing portion of the reserve requirement (eventually up to 50 percent) with liquid foreign assets represents an excellent way to improve the soundness and profitability of the banking without in any way impairing foreign reserves cover of the currency board. We therefore support and encourage the authorities to follow this road. In an environment in which more than 85 percent of bank assets are controlled by foreign banks it comes as no surprise that the main conclusion of the FSAP is that financial sector vulnerabilities in Estonia are not a matter of concern. Moreover, most of the Basel Core Principles are met by the BoE.

Regarding external accounts we share staff's caution with respect to the risk of a growing current account deficit. Notwithstanding the fact that it is now entirely financed by non-debt creating flows such as FDI and equity investments, it should not be forgotten that those flows will eventually reinforce the deficit through profit remittances. Moreover, although public external debt is very low, private external debt is already significant at around 45 percent of GDP. Regarding external competitiveness the continued growth in exports and the high flows of FDI are convincing signs that, despite the real appreciation of the currency, competitiveness remain strong and that there is still a margin to catch up from the substantial under-valuation of the exchange rates at the moment the peg was established as well as from the continued expansion of productivity. It is revealing, anyway, to see that the real effective exchange rate appreciation of the Estonian currency was much smaller than the other Baltic countries with less stringent exchange rate pegs.

Finally, on structural issues, staff supports the authorities' intention to broaden active labor market policies as a way to reduce the unemployment problem, despite its belief that active policies have usually not been very effective. I wonder if all available experience on this matter was considered and if subsidized on the job training programs are also part of these policies,

perhaps this is the most effective way to address the skill miss match problem underlying the phenomenon of unemployment in Estonia.

With these comments I support the proposed decisions and wish the authorities continued success.

Mr. Mirakhor stressed the importance of not making any judgment on the currency board itself without considering all of the other relationships. The currency board had served Estonia well, and should not be abandoned. The main question was whether the combination of the savings-investment balance, currency and domestic credit, and currency board actually created a fragility. The staff paper on the savings-investment relationship in the Baltics showed that in Estonia, the reduction in domestic credit in the aftermath of the banking crisis was the major force behind the swings in the private savings-investment balance. The situation in Latvia was different; the private savings-investment balance there was a response to the cycle itself and the savings-investment balance mirrored the current account changes in the country. While it could not be said that the current account deficit was not financeable or appropriate, Mr. Costa had suggested that the private sector had the largest external debt, and it was important to remember what had happened in some Asian crisis countries. In fact, private sector external debt had exacerbated much of that crisis. It was important to implement preventive measures and perhaps a debt workout, or some way of reducing the vulnerability of the economy to crises in the case of private sector external debt situations. However, it could not be assumed that just because the debt was in the private sector, the government would have nothing to do with it and it should not be a concern. It could not be dismissed that easily, especially as there were no effective preventive mechanisms set up to deal with such situations.

Mr. Costa said that he had referred to the relatively high level of private debt in the case of Estonia, but did not have information about to whom that money was owed. Perhaps they were Estonian residents, but there might also be foreign capital involved, so there was some possibility that the situation was not serious, even with external debt at around 45 percent of GDP.

The debt did not represent a major risk in any event, Mr. Costa continued. The question of how the currency board worked in a crisis was interesting, and some lessons could be drawn from the experience in Estonia. For example, the real exchange rate appreciation of Estonia was much less than that in other countries. Flexible exchange rates could sometimes be seen as allowing a depreciation and subsequent competitiveness gains. However, in good times, currencies appreciated more than the rest, which was believed to be case in Estonia. That was an evident advantage of flexible rates compared with a fixed exchange rate system.

Another important aspect of the Estonian experience was the velocity of the adjustment, Mr. Costa noted. GDP came down faster but also grew faster, which was possible in a currency board regime that did not wait too long for corrective measures to take place. Thus, comparing the performance of the currency board in the crisis with the other Baltic countries, the currency board system appeared to fare better.

Mr. Mori said that he was concerned from a policy making perspective about a country that in a short period started at 3 to 4 percent growth, rose to 10 percent growth, and one year later dropped to zero percent growth. The volatility present in the Baltics, Asia, and in Latin America had to be analyzed better. Even in a currency board or fixed exchange rate, it was important to look at some information more carefully, for example, the problem of the expansion in credit in the period before the crisis. The herd behavior after the crisis, which was seen twice in the 1990s, had to be avoided in the future.

Mrs. Zador said that she agreed fully with Mr. Mori, adding that it was important to understand better the main instruments available for economic policy under a CBA regime in order to avoid the boom and bust periods. Another major risk was how successfully a CBA could deal with large capital outflows and also with inflows, and how to absorb those flows without letting inflationary pressures build.

Mr. Costa responded that reducing volatility should not be the responsibility of a currency board, which seemed to be the trend in economies throughout the world. Such volatility was why so much emphasis was placed on financial sector assessments and on supervisory and regulatory issues in the banking system. A currency board regime had the advantage of reacting immediately. That might increase volatility, but might also give assurances that there would be fewer serious problems in the future. The volatility as such should not be attributed to a currency board arrangement.

The Acting Chairman observed that the Board had had a similar discussion comparing Singapore and Hong Kong in coping with the Asian crisis. Under Hong Kong's currency board arrangement, adjustments had taken place through changes in factor prices. In the case of Singapore, part of the adjustment had occurred through exchange rate adjustments. In both cases, because of the flexibility in the economy, the countries were able to overcome the Asian crisis in a relatively successful manner.

The staff representative from the European II Department said that, regarding the appropriate rate of credit growth and whether financial conditions were too tight to allow for economic growth to resume, credit growth to the private sector of about 10 percent was not inappropriate in light of real growth of 4 percent and an inflation rate of 3 to 4 percent. Moreover, large investments were being financed by foreign direct investment. Monetary expansion, which was proceeding at a much faster rate than credit growth, was driven by the growth of the net foreign assets of the banking system. Thus, it could not be said that financing conditions were tight. Interest rates were low, banks were liquid, and their capital asset ratios were comfortable.

Banks were becoming more particular about to whom they provided credit, which was a good development, the staff representative continued. Banks had learned a lesson from the previous recession, when certain loans had no longer been collectable. However, at the margin, some of the smaller domestic enterprises might have a hard time obtaining credit because they were not large enough to go to outside investors or to convince banks to lend to them. The largest concern, however, was the ease with which financing could be obtained from abroad.

The changes in reserve requirements were considered a contingency measure that the Bank of Estonia could use, if necessary, the staff representative commented. The staff did not consider that that policy tool should be used immediately; on the contrary, it was hoped that reserve requirements would decline over time toward the EU level. However, if the pace of lending were to again become unsustainable, in the absence of any control over capital flows, higher reserve requirements might be imposed. The staff's understanding was that the Bank of Estonia felt that commercial banks should not be forced to switch in and out of domestic and foreign assets, and thus should be allowed to meet some of the reserve requirements through highly liquid, high-quality, short-term foreign assets.

Argentina was one of the countries which the Estonians were looking at closely, as Mr. Costa had remarked, the staff representative continued. The reason for the high reserve requirement was not so much to control the money supply—the authorities were not pursuing any money supply targets—but to establish a liquidity buffer. The commercial banks had the same perception as the Bank of Estonia. Knowing that there was no lender of last resort under the currency board, the banks held high reserve, impact for earnings – related reasons in foreign assets rather than domestic assets.

It was difficult to assess the impact of the tax changes introduced on January 1, 2000, because there were many factors involved, the staff representative explained. There had been a surge in imports in December by importers trying to beat the tax increases, and that had not yet worked its way through the system. At the same time, there had been a turnaround in the economy, in the sense that an economic recovery was taking place. Judging from the first quarter performance, the tax changes had not led to any weakness in the budget. There had been a strong overperformance in that first quarter, although the staff did not expect an equal size budgetary overperformance in the second quarter, in part because an extra month of wages was traditionally paid to teachers in the second quarter for summer vacation.

The authorities generally wanted to proceed cautiously on the financing of pension reform, the staff representative reported. The government's first instinct was to aim at a balanced budget as much as possible, although cyclical fluctuations might not always make that goal practical or advisable. In such instances, the use of stabilization reserve fund resources would be a reasonable approach.

The staff did not fully understand the reason for the rise in unemployment to nearly 15 percent, in the first quarter of 2000, the staff representative informed. The official statistics were good in the sense that there was a clear distinction between those unemployed who got benefits and those who did not. Mr. Yakusha was right to suspect that geographical elements were involved in the unemployment level. The recession had helped the restructuring of the economy which, as noted by Mr. Mori, had led to the creation of new jobs that could not easily be filled by workers who had been released from old industries. That was partly a geographical problem because of the concentration of old-style industries in the northeast, close to the Russian border. The population there had a high number of Russian speakers who, for language reasons, found it difficult to enter the service sector, for example, which was growing rapidly in Estonia's capital. That problem needed to be addressed through targeted language programs as well as greater mobility. There was also a

question of whether the housing market was able to supply the necessary apartments in the high-employment areas. It was difficult to say what portion of unemployment was structural and what was cyclical, the staff representative explained. The staff considered that a fairly high portion of unemployment had become structural in nature, because the recession had in effect eliminated some of the old-style industries.

The issue of current account sustainability had been widely debated within the staff and also between the staff and the Acting Chairman, the staff representative commented. The staff's view was that, to the extent that there was a risk that foreign direct investment might decline, there would also be an automatic adjustment to the current account, which was driven by foreign direct investment. While there would not be a one-to-one offset, it was clear that many of the investments, for example, in hotels or electronic manufacturing, would not take place without foreign direct investment. Thus, the staff considered that the financing gap created by a shortfall in FDI would be partly offset. Furthermore, public sector debt in Estonia was low and the government had an excellent credit rating, as did many private entities. Therefore, there was room for bridging fluctuations in the influx of foreign direct investment, which would allow for a smoothing out process.

Stock market prices had not yet returned to the highs experienced two years previously, which had been linked to the overheating of the economy, the staff representative observed. The stock market was especially driven by one or two large companies, thus it was difficult to make any prediction about whether the stock market trends would be reversed.

Public sector wage increases in 1999 had been high largely because of policy laxness in the run-up to the election, the staff representative explained. When the decisions to increase the wages had been made in 1998, there had been a fair amount of calculation about economic prospects. The Russian crisis, and the resulting slowdown in the economy had not been foreseen. In the 2000 budget, currently being implemented, wages and pensions had been frozen to correct for those excessive increases, and it was the staff's understanding that the government would at best give moderate increases for 2001 or possibly again freeze wages.

Subsidized training was seen as an effective labor market tool but was only available to those registered as being unemployed, so eligibility was somewhat restricted, the staff representative noted. The government was considering broadening the eligibility for that program, although with the unemployment rate rising, the budgetary consequences would have to be assessed.

One of the problems with the currency board was not just the potential for capital outflows but for capital inflows, the staff representative commented. The lack of tools to limit capital inflows posed a particular challenge. There was a burden on banking supervision to ensure that banks did not translate their easy access to foreign financing into a repeat of the fairly extreme rates of credit growth seen in 1997.

On the question of volatility of output, as a small country, Estonia did not have the same diversity as other countries and was much more dependent on external markets than on

its own markets, the staff representative explained. It was thus more exposed to shocks, both positive and negative. Estonia was currently experiencing positive effects from fast growth in the European Union. It was not clear whether programs could be designed to limit that vulnerability, as the shocks were mainly from the external side. Unless the fixed exchange rate regime was abandoned, which would have other drawbacks, it would be difficult to have a countercyclical policy that could significantly dampen the fluctuations. In the case of the 1999 budget deficit, the automatic stabilizers mitigated the impact of the crisis somewhat, but there were limits to that, especially in light of a country's indebtedness.

The authorities believed that fixing the exchange rate permanently against the euro, after 7 to 8 years of successful fixing to the deutsche mark under a currency board, would not constitute a major risk, the staff representative remarked. The exit option would then be more permanently precluded. However, there were also arguments against doing that. One was that the ECB had specified a protocol about how to join the common currency area, starting with EU membership, then participation in ERM II, and only thereafter moving to the adoption of the euro. The argument against taking those steps unilaterally was that that would preclude the Bank of Estonia from being represented on the Board of the ECB, and would mean a substantial loss of seigniorage. If Estonia were to unilaterally introduce the euro, it would have to buy euros. While as a member of the eurozone it would have to surrender part of its exchange reserves, would be much less costly than buying the entire money supply outright.

The staff representative from the Policy Development and Review Department said that there was a distinction between support for the currency board arrangement up to the time that Estonia would join the euro area, and euroization, which was quite similar to dollarization, prior to joining the euro area. The Board was quite familiar with the debate on the pros and cons of a currency board and dollarization. There had been a recent staff paper and seminar on that topic for Argentina, which had compared the currency board arrangement in Argentina and the dollar arrangement in Panama. Those issues applied to the case of Estonia as well. A fundamental question was the magnitude of the gains from of interest savings. According to Figure 5 in the staff report, there was a difference of 150 basis points between what commercial banks paid and the euro rate for European banks. That difference might also reflect a difference in the credit quality of the banks, so it was difficult to know what part of that involved the credit rating and what part involved the currency risk associated with the currency board. Panamanian banks paid a premium of about 150 basis points, while the Panamanian government paid a premium of about 450 basis points, which suggested that credit and currency risk could be distinctly different. Panama had a debt ratio of about 70 percent of GDP, while in Estonia that was believed to be zero. Thus, it was important to make a distinction between the reasons for the higher interest rate costs, and whether they would be eliminated by moving to eurorization.

The seigniorage costs of euroization could be substantial, the staff representative continued. In addition Estonia's central bank, would lose the ability to provide emergency liquidity if it moved to an early euroization because the central bank could not print euros. As regards regards the lender of last restart function, euroization would not bring about a change because lender of last restart function was not a responsibility of Estonia's Central Bank.

The ECB had made it quite clear that there had to be a common understanding about the parity rate for entry into the euro area between the ECB and the country, the staff representative noted. The time path for joining the euro area was intended to address nominal and real convergence. For example, there was 3 to 4 percent inflation in Estonia, which was substantially higher than inflation in the euro area and above the requirements that would apply under the Maastricht criteria. While higher inflation may relate to the Balasa-Samuelson effect, the question was whether there might not be advantages to waiting. Those were the considerations involved in weighing whether or not the early, unilateral adoption of the euro was a desirable policy option for the authorities.

Mr. Lehmuusaari made the following concluding remarks:

Let me thank the Board for the interesting comments. Estonia was discussed by the Board just a few months ago and many of the points were raised during that discussion. I have just a few remarks.

Regarding the FSAP and the financial sector, my authorities both in the Bank of Estonia and the Ministry of Finance are happy about this assessment, and I want to convey their thanks to the staff in both the Fund and the World Bank. The authorities only regret that this report cannot be published as such, but I fully understand that this is the Fund's policy at present, only the ROSC section will be published.

There is no need to go through the findings of the staff report, but the basic finding is that things in the banking sector are good, although there is some room for improvement in the non-bank financial sector. My authorities are working on several fronts to improve those shortcomings.

It is always possible to raise the question whether there is enough competition in the banking sector. Yesterday the Bank of Estonia finalized the sale of the Optiva Bank to the Finnish Bank insurance company, so there are four major banks operating in the Estonian market. It is true that 85 percent of those banks are owned by foreigners. At the same time, I do not believe that market shares have stabilized. There will be some reshuffling in the future so competition should improve.

Regarding the currency board and Estonia's access to the EU and the EMU, the present arrangement is considered to be the best option for Estonia to go forward. In terms of the requirement that each country should participate in an ERM II arrangement before joining the EMU, there are two things to consider. One is the legalistic part of ERM II; some of the comments from the ECB may have been led by the fact that some of the legal experts felt that the currency board would perhaps not meet all of the requirements of the treaty. It appears that after some thinking they reversed their position, and the CBA will now fulfill the requirements. I think that the Fund played a crucial role in

that process and the discussion became much more balanced. The Estonian authorities benefited directly from that discussion.

The negotiations on the accession have proceeded well and the government plans to join the EU on January 1, 2003. The most complicated chapters have already been opened, mainly dealing with agricultural issues, which are the most difficult part of the discussion and negotiations.

Privatization was not raised much during this discussion, but Estonia has privatized everything it can at present. There are a few state-owned infrastructure companies left, which are also undergoing privatization.

There has been much discussion over the past year of how to change the pension system. There was a decision made recently that the government would go to the second pillar. It was originally thought that it should be mandatory, but subsequently concluded that it would be voluntary. The details of the financing are not available, but perhaps the Board can look at those issues when it meets again.

Unemployment remains relatively high in Estonia, but this is to some extent unavoidable with such a rapid transition. It has to do with rigidity, although not in the labor market, which is absolutely flexible. It is completely different if you compare the labor market in Estonia and those in other parts of Europe. The problems must involve, as pointed out by the staff, a mismatch of skills as well as regional rigidities. These issues are being addressed by my authorities.

I want to thank the staff for the excellent set of papers. The pension paper was particularly valuable and has a large number of references to various sources to study the problem. There have not been any major disagreements between my authorities and the Fund staff.

The staff representative from the Policy Development and Review Department said that, regarding Mr. Lehmussaari's comment that the authorities regretted that they could not publish the FSSA report, those reports were not to be published at least during the pilot phase of the program. The staff report would be published in its entirety under the pilot program for the publication of Article IV staff reports; Box 3 contained the summary of the main conclusions of the FSSA and FSAP report, and Section D of the staff report also discussed the FSAP/FSSA. As Directors had discussed in other cases, there was some tension between the two publication policies. However, the staff felt a comfortable with the balance struck between those two policies, and it was up to the Board to indicate whether it was also compatible.

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

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the further strengthening of Estonia's economic performance in the recent past. The recovery has gained momentum, inflation remains low, and confidence in the currency board remains high as evidenced, inter alia, by the convergence of interest rates toward euro-area levels. Directors emphasized that these favorable developments owed much to the authorities' policies. They stressed the importance of maintaining the fiscal consolidation effort under the currency board arrangement. Directors saw fiscal policy as critical in providing a favorable climate for sustained economic growth, including by regulating demand pressures to prevent overheating and an excessive external current account deficit. Against this background, they welcomed the reduction in the fiscal deficit in early 2000.

Directors agreed that the fiscal targets for 2000 and 2001 remain appropriate. They welcomed the authorities' commitment to take any corrective actions needed to achieve them, and noted the authorities' intention to target a budget surplus next year should the economy perform better than expected. Directors emphasized that, to safeguard the fiscal position, firm expenditure policies must be in place before proceeding with the planned reduction in taxation in 2001, and that recent revenue measures should be fully implemented.

Directors agreed that the currency board arrangement should remain a cornerstone of Estonia's economic strategy in the lead-up to EU membership and under ERM II. They emphasized the importance of appropriate macroeconomic and structural policies, particularly in the labor markets, to support the currency board and maintain external competitiveness.

Directors noted the recent rebound in broad monetary growth, partly caused by balance of payments inflows. They noted the challenge for policymakers that could arise from the possibly destabilizing effects of abrupt swings in the banking system's recourse to foreign borrowing, and in the saving-investment balance of the private sector. The Bank of Estonia will need to monitor developments very carefully to forestall any excessive growth in credit. While reserve requirements are already high, Directors warned that a further increase may become necessary to restrain domestic credit expansion. They also stressed that banking supervision must ensure that banks do not unduly relax their internal risk management procedures.

Directors welcomed Estonia's participation in the pilot Joint Bank-Fund Financial Sector Assessment Program. They noted that financial sector vulnerabilities have been markedly reduced over the past few years, largely reflecting bank consolidation and restructuring (including, importantly,

foreign ownership). Banking supervision has also been considerably strengthened. Directors welcomed Estonia's compliance with many of the Basle Core Principles and encouraged the authorities' effort in areas where compliance is not complete. They considered that non-bank financial supervision should be strengthened, and supported the move to unified supervision of the financial sector by a new agency. Directors stressed that this new agency should have adequate budgetary and operational independence, as well as powers to issue and revoke licenses.

On pension reform, Directors agreed that a second, fully funded, defined contribution pillar has certain advantages, but that it would not, by itself, solve the issues arising from the adverse demographic shift. For this, further reform of the first pillar would be required, including a more ambitious and faster increase in the pension age. Directors stressed that care would need to be taken that the transition costs associated with a second pillar are constrained to avoid budget pressures or an excessive increase in public debt.

Directors commended the substantial achievements with regard to structural reforms and the priority accorded by the government to making further progress toward EU accession. They praised the establishment of a well-functioning market economy, the maintenance of a very open trade and payments system, and the fostering of a conducive environment for foreign direct investment. Directors noted that discussions with potential investors were moving forward concerning the privatization of the few remaining major state assets.

Directors were concerned that, notwithstanding a high degree of wage flexibility, the ongoing restructuring of the economy in combination with mismatched skills has resulted in a high level of unemployment. They recognized that this, in part, resulted from the fact that the authorities had resisted measures that would have slowed the transformation of the economy. Nevertheless, Directors emphasized the importance of addressing—including through targeted active labor policies—the problems related to high unemployment, not least in order to preserve a social climate favorable to the continuation of reforms.

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

The Acting Chairman made the following summing up on points relating to the first review under the Stand-By Arrangement:

Directors observed that the authorities had established a strong track record in implementing their program of economic and structural reform, and commended them for having observed all performance criteria for end-March 2000. Noting the authorities' commitment to maintain the currency

board arrangement in the lead-up to EU membership and under ERM2, Directors approved the completion of the first review under the Stand-By Arrangement, which the authorities continued to treat as precautionary.

Looking forward, Directors welcomed the determination of the authorities to push ahead with their strong reform program aimed at raising incomes and employment opportunities as well as meeting EU accession requirements. While fully supporting the authorities' policy commitments and noting their strong track record, they emphasized that there was no room for complacency. In particular, continuing firm budgetary discipline was essential to ensure the sustainability of the recovery getting under way and in order not to endanger progress to date in containing the current account deficit. In this connection, Directors welcomed the authorities' commitment to take the necessary measures to ensure a balanced budget for 2001, as well as their intention to achieve a budget surplus in that year should the economy perform better than expected. Directors endorsed the authorities' intention to proceed with a far reaching pension reform. As to the possible introduction of a fully funded second pillar, they noted the importance of ensuring that transition costs do not place an undue burden on the budget.

Ms. Vtyurina asked, regarding the staff's comment about publishing the FSAP information in Box 3 of the staff report, what would happen when countries wanted to publish the Article IV staff report but not do anything with the FSAP? It was understood that the Estonian authorities wanted to publish that information because it was favorable, but other countries might be in a different position.

The staff representative from the Policy Development and Review Department replied that the experience was limited in terms of the overlap between FSSAs and staff reports that had been published. Canada's staff report was the first published where there had also been a discussion of the findings of the FSSA report and the staff's views, both in the policy discussion as well as in the staff appraisal. In that case, there had been a long discussion about the publication of FSSAs, and in the end it had been decided not to publish it. The situation was similar in the case of Estonia. The main difference was that in the case of Estonia there was a box summarizing the main findings of the FSSA, which had not been the case in Canada. It was important to gauge the comfort level of the Board regarding the matter, because there was a tension between the two policies that the Board had established. The staff was comfortable with the publication of Estonia's staff report without any deletions, although that was an issue for the Board to decide.

Ms. Vtyurina asked whether the matter would be discussed on a case-by-case basis. It was not the usual practice to delete many items from Article IV staff reports prior to publication. If a country was not willing to have a box including the FSSA information, could it be taken out?

The staff representative from the Policy Development and Review Department responded that the policy on deletions for Article IV staff reports was that information had to

be market-sensitive, which would apply in the case of Estonia. There may be information in FSSAs that was market sensitive.

Mr. Mirakhor remarked that the Estonia Article IV staff report appeared to include more expansive coverage of an FSSA report than others before it. The staff had been conscious and conscientious in responding to the expressed desire of the authorities to publish the entire staff report, and, as that could not be done, had provided the FSSA references. That might be an optimal arrangement if the Board decided that it did not want to publish the FSSA report altogether but wanted have some coverage of it in the staff report. That position should await Board discussion, but it was hoped that, in the meantime, the staff would be sensitive to the issue and responsive to the views of the authorities.

Mr. Fenton agreed with Mr. Mirakhor's views and was comfortable with what the staff had done in the case of Estonia. The experience with the former Yugoslav Republic of Macedonia was that there had been an annex that included the FSSA material and the Board had agreed to delete it prior to publication.

The staff representative from the Policy Development and Review Department said that in the case of Macedonia, the Basel core principles assessment, which was included in the Annex, was deleted. The policy with respect to the FSSA was that the FSSA analysis should be integrated into the Article IV staff report. The staff had done that appropriately in the case of Estonia and it would do damage to the report to delete it. However, the staff was dealing with two conflicting publication policies. It would therefore be difficult for the staff to resolve the issue until the Board had dealt with a few cases and clear precedents had been established.

Mr. Yakusha commented that the Board might be contributing to the existing asymmetry of information by creating a precedent in the case of Estonia. If investors knew that an FSAP had been conducted and there was no box in the Article IV staff report, they might conclude that something was wrong, and that message might be conveyed to the markets. Therefore, a case-by-case approach would be more appropriate.

Mr. Mirakhor said that he agreed with Mr. Yakusha that the case of Estonia might be a way of establishing a policy, and that that might be preferable to having no policy at all. It was important to be responsive to the authorities' views, while, at the same time, being cognizant of the fact that there was no policy in place. There were only six more cases of FSSA countries in the pilot project. Once that project was complete, the Board would have to create a general policy on publication, but, in the meantime, the staff had served Estonia well. Such cases would not send a strong signal to the markets until the general policy was in place.

Mr. Woolford considered that it was appropriate to proceed on a case-by-case basis. The signal that that would send to the market was unclear, and there was a risk of rendering transparency as something that would allow countries to publicize good information but overlook bad information. It was important for the Board to be reasonably symmetrical in its treatment, especially if there was no policy.

The Acting Chairman said that management had looked carefully into the present policy on the publication of staff reports and on FSSAs, and found that the staff's action in the case of Estonia had been exactly in line with what had been decided on transparency vis-à-vis both reports. The FSSA was to be integrated into the Article IV process, so there should be some reference to the FSSA in the staff report. Nevertheless, that should not bypass the non-publication policy of the FSSA. Thus, there was a reasonable balance to be struck and as the Board was in the middle of the experimental stages of both exercises, the case-by-case approach was appropriate.

Mr. Borpujari said that he agreed with the consensus of the Board, although it was important for the Board to be consistent with what it had done in the past. To agree that the FSSA report should not be published and then to publish the information in the form of the Article IV staff report gave the impression of inconsistency, however unintended.

The Executive Board took the following decision:

1. The government of the Republic of Estonia has consulted with the Fund in accordance with paragraph 3(d) of the Stand-By Arrangement for the Republic of Estonia (EBS/00/18, Sup. 2, 6/2/00) and the second paragraph of the letter dated February 11, 2000 from the Prime Minister and the Governor of the Bank of Estonia.
2. The letter dated June 7, 2000 from the Prime Minister and the Acting Governor of the Bank of Estonia shall be attached to the Stand-By Arrangement for the Republic of Estonia, and the letter dated February 11, 2000 from the Prime Minister and the Governor of the Bank of Estonia shall be read as supplemented by the letter dated June 7, 2000 from the Prime Minister and the Acting Governor of the Bank of Estonia.
3. The Fund decides that the first review contemplated in paragraph 3(d) of the Stand-By Arrangement for the Republic of Estonia is completed. (EBS/00/101, 6/9/00)

Decision No. 12222-(00/65), adopted
June 30, 2000

2. HONDURAS—ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—DECISION POINT

The Executive Directors considered a paper prepared jointly by the staffs of the Fund and the International Development Association, on the decision point document for Honduras under the enhanced initiative for heavily indebted poor countries (EBS/00/114, 6/20/00; Sup. 1, 6/27/00; and Cor. 1, 6/29/00).

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

At the outset, our Honduran authorities would like to convey their deep appreciation for all the hard work deployed by staff and the advice received from management during the last two years, making it possible for the country to reach the decision point in the context of the HIPC initiative. The document prepared for this session is another proof of the deep understanding by staff of the Honduran reality, being also a testimony of the good working relationship between Fund's representatives and authorities.

Over the past several years, Honduras has made an impressive progress in the implementation of sound macroeconomic policies and strong structural reforms. Even after the huge devastation caused by Hurricane Mitch at the end of 1998, the authorities have managed to support the process of reconstruction while at the same time preserving macroeconomic stability and continuing with the modernization of the country. Backed by ESAF and PRGF programs, Honduras has undertaken important structural reforms including trade liberalization, the strengthening of the financial sector, and the public sector modernization. Progress has also been made in the social arena. In fact, over the last decade, social indicators have improved reflecting the government's priority of targeting expenditures on primary social services. As a result, Honduras's health and education indicators are above average related to other HIPC countries. Important safety net programs have been operating since 1990 to build social infrastructure and target assistance to compensate the most vulnerable groups. In any case, it is undeniable that Honduras' social indicators are still among the weakest of the region, with poverty affecting about two-thirds of the population.

Notwithstanding prudent and responsible debt management, strong adjustment efforts and debt rescheduling from bilateral creditors, Honduras external debt service continues to represent a substantial fiscal burden, absorbing a large proportion of the government's budget. In net present value terms the total external debt exceeds by more than three times the annual fiscal revenue and, even after the application of traditional debt relief mechanisms, it remains unsustainable. This constitutes a major obstacle for the country's economic development and efforts to reduce poverty, especially when taking into account that Honduras is still immersed in the reconstruction process.

Last December, during the discussion of the preliminary assessment of debt sustainability, the Board acknowledged Honduras track record in pursuing macroeconomic stability and implementing structural reforms and therefore agreed that the country was eligible for debt relief under the HIPC initiative. The completion of the second review of the PRGF program, along with significant progress in the privatization program and in the preparation of the Poverty Reduction Strategy Paper, were considered essential in order for

the country to reach its decision point. Our authorities have worked very hard during the past months in order to fulfill these conditions and the results are encouraging.

Completion of the Second Review of the PRGF

The second review of the PRGF was completed early this month, on evidence that our Honduran authorities have continued implementing sound fiscal and monetary policies and a strong agenda for reform. All the end-December quantitative performance criteria were met, except for a small deviation in the base money target. The results in economic growth, fiscal balance, public savings, and balance of payments were better than expected. Important progress was also achieved in the implementation of structural reforms. Among the actions accomplished was the approval of a plan to reform the Honduran Social Security Institute, which required a great deal of effort on the part of our authorities in order to reach consensus among the different political forces in the country.

Significant Progress in Key Structural Reforms, particularly the Privatization Program

During the past months, Honduras has continued advancing firmly in the process of privatization and other structural reforms. The following progress can be reported:

The Telecommunications Company is at the point of sale and the process will be finalized in July.

The selection of the concession holder for the operation of the four international airports was completed in March 2000.

The framework law on the electricity sector was at the third and final debate in the National Congress, before it went into recess this month, and is expected to be approved no later than September 30. Meanwhile, our authorities are making the preparatory work towards privatization of electricity distribution.

With IDB assistance, the government is designing a proposal to incorporate the private sector in the management, operation, and financing of seaports. This proposal is expected to be ready in October this year.

The framework law that would allow private concessions in the provision of water and sewage services will be approved at the end of this year.

Other structural reforms include the approval of a tariff increase for electricity in February 2000 and the continued strengthening of prudential regulation and supervision of the financial sector.

Our authorities have also been taking a series of actions for improving governance and transparency, especially following Hurricane Mitch. Reconstruction projects, for instance, are required to be approved by the Reconstruction Cabinet before being implemented in order to increase accountability, and the government has involved civil society in the monitoring of the reconstruction plan. Furthermore, with assistance from donors, a General Project Inspection Unit is planned for the near future, having as mandate the review of the quality, financing and transparency of all projects. In addition, with the purpose of enhancing transparency and efficiency in the procurement process, the government prepared a new draft procurement law, with support from the Inter-American Development, and submitted it to Congress. The IDB also just approved technical cooperation to support the entire process. Our authorities are also working in expanding the reach of the practice of integrated financial management through the public sector, to increase transparency of the budgetary process. Important steps have also been taken to strengthen the Office of the Comptroller General and the Office of Administrative Probity. Finally, with the objective of improving economic information, which is essential for the design, and monitoring of economic and social policies, the Congress approved last may the creation of a national statistics institute.

Progress toward the development of the Poverty Reduction Strategy Paper

The IPRSP presented recently to the Board includes a comprehensive diagnosis of the causes of poverty in Honduras and an analysis of the linking between poverty, growth and the macroeconomic framework. This document is in the process of being improved, incorporating the constructive comments and suggestions expressed by the Board at the time of the second review of the PRGF program. As it is mentioned in the staff's paper, our authorities are programming to use the resources freed up from debt relief for the strengthening of critical social and infrastructure programs. These expenditures will be consistent with the macroeconomic framework designed to achieve sustainable economic growth with financial stability. In order to enhance transparency in the use of these resources, the government plans to establish a poverty reduction support fund, similar to those established by other HIPC countries, to channel directly the funds released from debt relief and the privatization proceeds to the assigned social programs. This fund will be included in the annual government budget and will be supervised by a National Council formed by members of the government, civil society, and bilateral donors.

The main priorities of the government's social program described in the draft poverty strategy paper are: to expand coverage and quality of primary education; to improve efficiency of resources in the health sector especially in primary services; to reduce child malnutrition; to improve targeting the most vulnerable groups attended through the social safety nets; to improve water and sanitation services in the rural areas and to give more attention to rights and conditions of minorities.

Our authorities have promoted an intense and continuous dialogue with representatives of civil society, which will be enhanced through the preparation of the full PRSP and during its implementation.

Reform Policy Priorities for the Floating Completion Point

The policy reform priorities proposed for the completion point have emerged from the active dialogue between the government, stakeholders and civil society. Among these priorities stands out a comprehensive participatory anti-corruption plan which will be prepared with support from the World Bank and will be presented to the national and international community. The strengthening of the reform in education also forms part of the agenda and will be accomplished mainly through the increase in the coverage of the PROHECO program, which contemplates active involvement of the communities. Other social reforms include the strengthening of the basic health services for the poor and the improvement in the efficiency and targeting of safety nets. Also efforts will be intensified to accelerate the implementation of the reform of the social security system which, as the staff pointed out, is essential not only for improving the quality and coverage of health services but also for a sound pension system. In addition, the government has the firm commitment of deepening the reform of the financial sector by fully implementing the Basel Core Principles. It will also make every effort to keep macroeconomic stability and will take the necessary corrective measures if the targets are at risk, notwithstanding the upcoming elections next year.

Our authorities are fully aware of the need for continuing and intensifying the dialogue and consultations with civil society, in order to ensure the sustainability and successful implementation of the policies and reforms described.

Main Challenges for the Future and the Need of Interim Assistance

The government has a very ambitious economic and social program to fulfill in the coming years. The main objectives will be to preserve macroeconomic stability to bring the country to a path conducive to sustained economic growth and the creation of incentives to attract private investment. Our authorities consider that these elements will be essential for attaining

faster development and poverty reduction over the medium term. In order to accomplish these objectives, Honduras will require to continue implementing strict and strong financial policies, aggressive structural reforms, and a well-focused poverty reduction strategy. It will also need continuous support from the international community. Accordingly, our authorities are asking for as much interim assistance as possible from multilateral and bilateral creditors, to be able to accelerate the reforms of the social sectors and to support the most vulnerable groups, within the context of the poverty reduction strategy. Programs in education, health and safety nets will absorb most of the resources freed-up from debt relief, with the remaining resources being allocated to the financing of low income housing, rural and environmental programs. A fixed percentage will be assigned to the administration, monitoring and auditing of the expenditures. The inflow of official resources in the form of grants and/or highly concessional loans will be also essential to allow the country to continue with the reconstruction and transformation process.

We reiterate the commitment of our authorities to continue with the stabilization and reform efforts, notwithstanding the coming electoral period. They are aware that it is fundamental for the country to persevere in applying a consistent policy framework, so as to create an environment that would lead to enhanced investment and additional growth capacity. The current administration intends to work up to the last day of its period following the guidelines and commitments that are clearly stated in the memorandum of economic policies and in the interim poverty reduction strategy paper.

Finally, our authorities are very grateful to the international community for supporting Honduras' reform efforts and debt relief. The recent preliminary agreement reached by the working group of the Board of Governors of the Inter-American Development Bank (Honduras' largest multilateral creditor) for providing debt relief to the Latin American HIPC countries is very encouraging. They also want to acknowledge the favorable agreement reached with the Central American Bank for Economic Integration (CABEI), being the first multilateral bank in securing debt relief for Honduras.

Mr. Milleron and Mrs. Mateos y Lago submitted the following statement:

We already had a chance to discuss the Honduran economy quite extensively only a few weeks ago, at the time of the second review of the PRGF arrangement, therefore I shall limit myself to answering the questions raised by Staff at the end of the decision point document.

Eligibility and the decision points

We agree that Honduras has met the conditions for reaching the decision point under the HIPC initiative, though with two provisos:

First, we would have been more comfortable with the appraisal of satisfactory progress of key structural reforms if we had had this discussion after the actual completion of the privatization of HONDUTEL and passage by Congress of the Electricity Sector Framework law ; we understand that both issues are expected to be resolved within a few weeks, but given that they have already experienced a number of delays, it would have been preferable to wait until the actual fulfillment of those two conditions to determine that Honduras has reached the decision point. In particular, we fear that anticipating the final vote of Congress on the very controversial Electricity Framework Law might create political difficulties for the government to secure its approval.

Second, we do not challenge the Staff's view that "satisfactory progress has (...) been made toward the preparation of a PRSP by completing the I-PRSP", but in our recollection of our last Board meeting on Honduras, executive directors expressed a number of substantive concerns on this I-PRSP, which went somewhat beyond the comments made in the Staff's appraisal, and we would have liked to see Directors' comments better reflected in the decision point document.

Amount and delivery of assistance

We agree with the Staff's recommendations regarding both the amount of assistance and the provision of interim assistance by the Fund between the decision and the floating completion points. Nonetheless, we would like to flag that further data reconciliation with the Paris Club will be needed, as the Staff's estimate of the stock of debt owed to Paris Club creditors is somewhat smaller than their own estimate of that stock.

We are also a little concerned with the actual status of some of the contributions treated as funding assurances in the document, and would appreciate hearing from Staff an update on that issue.

Conditions for the floating completion point

We think that the triggers described in section IV of the document are broadly appropriate, though for some of them further specification might be warranted.

Firstly, as regards implementation of the social security reform plan, we were wondering whether it was realistic to expect full implementation of

the plan within the next couple of years and whether it would not be more practical to define several stages of reform, which would facilitate the appraisal of how much progress has been made at the time of the completion point.

Secondly, regarding the strengthening of basic health services, we have no doubt that reaching a minimum of 100,000 beneficiaries is a worthy goal, but we would have liked to find out how this target relates to the current coverage of basic health services. In addition, it might be worth adding that this target should be sustained in time or even expanded, so that it be reached not through a one-time exceptional effort, but through adequate institutional developments.

Thirdly, as regards the efficiency and targeting of social safety nets, we would like to know whether the trigger is meant to imply that all social investment projects in beneficiary municipalities should be implemented based on participatory planning methodologies, or only some of them, no matter how few. Needless to say, we would strongly prefer the former.

Fourthly, we appreciate very much the trigger related to the strengthening of the financial sector, but we wonder to what extent the goal set is realistic, in particular in view of the limited implementation capacity both within supervisory authorities and within commercial banks.

Having answered all the questions raised by the Staff, I would also like to compliment them for this short and well-written document, which is particularly informative as regards the division of labor between the three major multilateral creditors and also gives a detailed account of the intended use of HIPC debt relief. In this connection, we also want to state that we welcome the establishment of a poverty reduction support fund to administer the proceeds of debt relief.

Finally, we support the proposed decision and wish the Honduran authorities well in their future endeavors towards the completion point and beyond.

Mr. Morais submitted the following statement:

The Honduran authorities have shown strong commitment in pursuing prudent macroeconomic policies and have advanced their reform agenda, despite the setback and devastation caused by hurricane Mitch. The effort of the international community has also been very encouraging including the reconstruction programs being supported by the IFC, IDA, IADB and others.

On the issues for discussion, it is important to consider that the authorities have performed well under the ESAF and the current PRGF. The

macroeconomic environment remains stable, education and health have benefited from increased budgetary allocations and social indicators are showing improvement, output growth has been buoyed by the reforms and the country is set on a steady recovery from the hurricane. We note that the privatization of HONDUTEL and the approval of the legal framework for the Electricity Sector are expected in the coming weeks. Taking this into account, we are satisfied that the authorities have fulfilled the conditions established for the decision point.

Regarding interim assistance, it is clear that the high debt burden continues to be a serious obstacle to the availability of public resources. We therefore support the view that Honduras deserves and needs as much interim assistance as possible to accelerate reforms, meet the needs of reconstruction and protect the vulnerable groups of society.

Regarding delivery of assistance, we welcome that the CABI and the IADB have indicated their willingness to grant debt relief to HIPC countries in the region. This is particularly encouraging in view of the problems that multilateral development banks were facing in this regard. We also support the need for data reconciliation raised by Mr. Milleron and Mrs. Mateos y Lagos.

On the conditions for the floating completion point, we would emphasize that debt relief is even more urgent in the particular case of Honduras and would caution against making the conditions too onerous. It is clear that the authorities have shown firm commitment to reforms, though implementation capacity could be limited in some areas, particularly in financial sector reforms. It is also useful to be prudent on those reforms that would require legislative approval, including social security reforms. There are also the complexities of an election year which we should bear in mind. Finally we give credit to the authorities for having devised an efficient and effective infrastructure for channeling debt relief, including the targeting of assistance to vulnerable groups and we support their efforts in further improving the system.

We support the proposed decision and wish the authorities well in their reforms.

Mr. Ondo Mañe submitted the following statement:

Early this year, Honduras met most of conditions to qualify for HIPC Initiative. Indeed, over the past several years Honduras successfully performed structural reforms and macroeconomic stabilization that allowed the country to make strides in economic management. Furthermore, its status of PRGF-eligible and IDA-only country, coupled with the heavy debt-servicing, laid the ground for reaching the necessary conditions for the

decision point. Conditions relating to the second review of the PRGF program have been met.

During the previous Board meeting, I underscored the impressive progress made by the authorities in reversing the difficult economic situation left by Hurricane Mitch and the scope of the achievements in many areas, including macroeconomic stabilization and structural reforms. With the support of the international community, the authorities continue their efforts to encompass many other areas, of which the banking sector and social security. These achievements have permitted the authorities to meet the PRGF-supported program performance criteria, except one. As a result, fiscal and monetary policies are on track, the outlook for 2000 remains positive and the conditions for reaching the decision point have been met.

Despite these positive achievements, Honduras economy continues to face daunting challenges and remains vulnerable. Also challenging are the social security and the banking systems where management remains weak and reforms are often delayed.

Notwithstanding severe external shocks, the authorities remained firm on the policy implementation, while continuing to improve other areas of concern such as the social sector, transparency and governance. The authorities' commitment has also been evidenced by the broad participation by the government, the private sector, and the civil society in discussions of the PRSP. In our view, there is no doubt that the authorities are determined to go as far as needed in reforms that could reduce the poverty, particularly by improving education and health. By doing so, they comply with the conditions of the preliminary document on the HIPC Initiative and, subsequently, Honduras is eligible for the HIPC Initiative and has complied with the conditions of the decision point.

We support Honduras' authorities for their endeavor and note that they have a very comprehensive agenda as regards the strategy in key social sectors with emphasis on education, health, nutrition, safety nets, potable water and sanitation, (Box 1). As we stated earlier this month, the authorities should focus on far-reaching structural reforms and poverty reduction through the Master Plan for Reconstruction and Transformation (MPRT). To this end, the PRSP which is quite comprehensive can contribute to lay a solid foundation for closer dialogue among the population. We strongly encourage the authorities to fully comply with the social program in the PRSP, so as to improve further the conditions of the population, particularly the poorest segments. In the same vein, we encourage them to tackle without delay the planned macroeconomic and structural reform under the PRGF for the period 2000-2002 (Box 2). In this area, the pursuit of the privatization process and the improvement of governance and transparency cannot be over-emphasized since they are central to economic reform.

As regards the amount and delivery of assistance, we welcome the collaborative scheme constituted by the World Bank, the IMF and the IDB in dealing with Honduras' challenges. We, therefore, agree with the staff recommendations of providing interim assistance between the decision and the floating completion point. Table 13 shows that external debt service after traditional debt relief may not be significant over the period 2000-2009. On the other hand, after HIPC debt relief, the NPV of debt-to revenue ratio will be shifting from its present level of 304 percent to 73 percent by year 2007. This could endow Honduras with important resources to support efforts toward poverty reduction.

To achieve this goal, we note that the Bretton Woods institutions, the IDB and the Central American Bank for Economic Integration (CABEI) are playing a leading role as main multilateral creditors. The Paris Club debt share is the third of the total debt and its contributions to NPV reduction would amount to US\$ 169 million. Since operations will take place before and after the floating completion point, we would like the staff to indicate their magnitude during the interim period and after. It is, however, encouraging to note that all the parties involved are working hard to meet the deadline. Clearly, the interim assistance provided by the World Bank and the Fund will help Honduras get prepared for the floating completion point.

Concerning the completion point, we agree that a set of reform measures be successfully implemented to further strengthen Honduras structural reforms to help pave the way for a sound poverty reduction process. These will include the participatory process, an anti-corruption strategy, a reform of the social security system, the strengthening of basic health services for the poor as well as the improvement in the quality of education. If these measures are successfully undertaken, there is no need for a compulsory endorsement by the Board of the Fund and the IDA of the first annual report on implementation of the PRSP before extending assistance to Honduras.

In conclusion, Honduras so far has made remarkable progress and deserves strong assistance from the international community. Regional development banks are playing hard their part of commitment and we would urge the Word Bank and the Fund to participate actively at an early stage in assisting the country.

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

We welcome the opportunity to consider the Completion Point for Honduras under the original HIPC framework alongside a Decision Point under the enhanced initiative. We recently considered Honduras' performance under its PRGF arrangement, and discussed the I-PRSP. There is no need to repeat our previous points now, though the issues relating to the quality of the

poverty diagnosis, transparency, governance and broad participation of civil society are still relevant.

In general we consider the paper to be well balanced and broadly agree with its recommendations and we can answer in the affirmative to the issues for discussion raised in paragraph 36. We would like to focus our remarks on three main issues: participation, triggers for completion point, and the special poverty fund, before closing with two more technical questions.

On participation, whilst the paper is generally positive about developments so far, we believe that this remains one of the key challenges for the development of the full PRSP. Full participation, by a wide range of civil society, along with commitment from government, will be critical to building the ownership that will be central to the poverty reduction process.

In the conditions for Completion Point, participation seems to be somewhat limited to the anti-corruption strategy. We believe that the government is committed to consultation, but the challenge will be to ensure that this is carried out. We stress the need for the authorities to be proactive in this area. We do not see effective participation simply as a hoop through which HIPC's must pass; rather we believe that it is central to the new effort to link enhanced debt relief to poverty reduction. A mechanism which enables ongoing consultation between government and civil society during the development of the full PRSP, and during its implementation, will be vital. We would hope that some of the funding made available through interim relief, possibly augmented by donor resources, could be used to support such efforts. The timetable for the preparation of the PRSP, shown to be from July 4 to August 4, and involving 'consultation' at the national level (based on meetings in Tegucigalpa and six major cities) seems a little short if the process is really to give a voice to civil society.

We generally agree with the triggers for Completion Point which focus on the quality of education, health, safety nets, improvements in the financial sector and, importantly, anti-corruption efforts. We understand that in the absence of a full PRSP it was not possible to set out more detail on the measures aimed at poverty reduction; nevertheless, measures relating to rural development or the inclusion of the poor—both of which were covered in the IPRSP—could have been incorporated. Monitoring of performance will be of particular importance in the period from now to Completion Point, and in the period beyond. Whilst monitoring is mentioned in document, it is disappointing that the only reference is to IFI staff and not to the authorities' role or, even more ambitiously, to civil society.

We would have welcomed more details on the design and likely operation of the poverty reduction support fund (PRSF), though we do note that these are still under consideration by staff. As in other countries such

funds can provide a helpful mechanism to manage HIPC resources in a transparent way. It will, however, be vital to ensure that the PRSF is incorporated into the national budgeting process. Given this, we welcome the intention to include the PRSF in the annual budget and to administer the fund through the Ministry of Finance. We also welcome the intention to devote 2.5% of PRSF resources to administration, monitoring and auditing. Do staff have any information on how the supervising national council will be selected?

We hope that social spending commitments not included in this fund (but also made by central government) can be maintained at least at current levels in real per capita terms. This is important not just because of the significant social needs, but also because in recent years social spending has been increasing in real terms at a slower rate than population growth. Are such provisions made in the MTEF?

On a more technical point regarding the debt sustainability analysis, we would welcome any information that staff can provide on how debt to neighboring countries has been handled. We understand that this has been an issue of particular concern to the authorities.

Finally, we are somewhat concerned by a presentational problem in the case of HIPC relief for Honduras. Decision Point will lead to a rise in actual debt service payments: from \$167m in 2000 to \$276m in 2003 (Table 14—though para 23 says 1999 debt service due was \$277m). We presume that this is linked to the debt service moratorium after Hurricane Mitch, depressing the 2000 figure. Given this, it will be very important to have figures available showing actual debt service payments going back a number of years so that we can show a more contextualized (and positive) picture. We would be interested to see average actual debt service payments for the three years before Decision Point compared to the three years after. We have asked for this information in a number of cases (as has been provided previously) and were disappointed that it was not provided in this case.

Mr. Houtman asked the staff to clarify the changes outlined in the correction to the staff report that had been issued shortly before the current Board meeting.

The staff representative from the Western Hemisphere Department indicated that the changes did not affect the substance of the staff's analysis or calculations, as they concerned small corrections in a few estimates related to the external debt.

Mr. Carstens thanked the staff and management for their efforts, both in the preparation of the document and in their discussions with the Honduran authorities on the enhanced HIPC Initiative. Substantial progress had been made, and the constructive dialogue that had been established would be useful to move forward rapidly in relevant areas.

With regard to the comments made by Directors in their preliminary statements, Mr. Carstens clarified that the consultation process linked to the PRSP was a continuous one, and that the president and the government attached high importance to the ongoing outreach efforts aimed at ensuring broad-based participation. A key concern was to make the interaction between non-governmental organizations (NGOs) and the authorities as effective as possible. Some NGOs did not have reasonable opinions, however—including those that wished to establish price controls and to stop the privatization process—and some of their views were in stark contrast to the objectives promoted under the enhanced HIPC Initiative. Therefore, a filtering process was necessary to enhance the authorities' outreach efforts and to improve communication. The authorities were determined to involve civil society in various aspects of the enhanced HIPC Initiative as effectively as possible.

Mr. Weisman made the following statement:

We support the decision point for Honduras. Our endorsement reflects a recognition of the authorities' important efforts to establish a solid macroeconomic and structural framework to support growth, and the initial efforts to develop a participatory process for formulating a poverty reduction plan. HIPC debt relief will allow Honduras to build on the progress made in recovering from Hurricane Mitch and will provide a unique window of opportunity to focus on critical reforms that will support growth, poverty reduction, and good governance.

The authorities expect to complete the PRSP by March 2001. Allowing for a minimum one year of performance implementation under the PRSP and an annual report endorsed by the World Bank and Fund Boards, the floating completion point could be reached in early 2002. However, Honduras faces serious challenges on both the macroeconomic and poverty alleviation fronts and must make progress on both if we are to support the completion point.

We appreciate the update on structural reforms as provided by Mr. Carstens and Mrs. Del Cid-Bonilla, particularly the developments in the privatization processes of the telecom and electricity sectors. But we share the view expressed by Mr. Milleron and Mrs. Mateos y Lago that completion of the telecom privatization and passage of the legislation on the electricity sector would have provided us with a much higher degree of comfort in endorsing this decision point. Honduras lags behind most other Central and Latin America countries in this area, and we would emphasize that to address efficiency concerns, follow-through on privatization is essential in order to meet anticipated investment needs over the medium term. We will expect to see substantial additional advancement in privatization prior to the next review of the PRGF and before we endorse the completion point for Honduras.

We fully support the inclusion of specific conditionality associated with governance among completion point triggers and welcome as steps in the right direction the recent efforts in this area outlined in Mr. Carstens' and Mrs. Del Cid-Bonilla's statement. More broadly, we are looking for the preparation and implementation of a participatory, comprehensive, anti-corruption strategy and its presentation to the national and international community.

We also will be monitoring the fiscal situation very carefully. In light of past problems with fiscal slippage in election years, we urge the authorities to refocus their attention on fiscal discipline. An important problem in this area is that the central government wage bill has continued to swell despite urging from the international financial community to address this problem and free resources for social spending. Satisfactory performance on this front will also be important in our determination on the completion point.

In general, we support the completion point triggers identified in section IV of the document, where, according to the text, the triggers are meant to "complement or reinforce" the PRGF program, as well as ongoing or future World Bank and IDB operations and, where, according to Mr. Carstens and Mrs. Del Cid-Bonilla, the triggers emerged from the active dialogue between the government, stakeholders, and civil society. While the triggers appear sound, we would ask staff to elaborate on how and why these particular triggers were selected. We would also request that the World Bank representative comment on whether, in the Bank's view, these triggers are the most important measures for promoting growth and supporting poverty reduction and how the Bank will ensure that its overall country lending strategy is supportive of the core objectives achieved by these measures.

With regard to debt sustainability, we would appreciate additional detail on the assumptions involved, particularly with regard to export growth. A primary focus of the HIPC process is sustainable debt relief, and we are not entirely convinced that these particular assumptions are realistic. Specifically, the analysis projects exports to grow at 18 and 19 percent in 2000 and 2001, and 15 to 16 percent from 2002 through 2004. Yet in 1999, the Article IV report forecast exports would grow at a more moderate rate. In previous discussions, staff noted to us that they based their revised export growth rates on assumptions of a recovery of agricultural exports after hurricane Mitch, as well as an increase of non-traditional exports, spurred by economic recovery, transport deregulation, and recent trade agreements with Mexico and Central American countries. How comfortable is staff that these developments will lead to the sustained high export growth levels indicated, and how sensitive is the debt sustainability analysis to achievement of such high export growth rates?

We appreciate the very clearly articulated section on Use of HIPC Debt Relief and also found Table 16, illustrating governmental operations before and after HIPC interim debt relief very helpful.

With reference to the PRSP, we welcome the government's commitment to work with the World Bank to increase decentralization of the health ministry, remove inefficiencies in the budget system, and strengthen links between hospitals and primary health systems. We note that the completion point trigger in the area of health calls for increasing delivery of basic health services to at least 100,000 persons and wonder what mechanisms are in place to assess whether this condition has been met and, echoing Mr. Milleron and Mrs. Mateos y Lago, what the baseline figure is as a means of comparison. Concerning the HIV virus, we note from the World Bank CAS that the prevalence rate of the disease is about 1.5 percent. Though this rate is well below those in some African nations, Honduras accounts for about half the HIV cases in Central America. Despite this situation, there is scant attention to this issue in the Interim PRSP, and we would inquire whether staff believes enough is being done to address the disease.

Along with Mr. Collins and Mr. Kelmanson, and acknowledging Mr. Carstens's opening remarks, we would emphasize the importance of adequate consultation with all stakeholders in setting the new development agenda, including civil society, bilateral donors, and the IDB, as well as in monitoring progress towards development goals. We are concerned that early progress on participation has not been sustained of late and that no concrete plan has been articulated for renewing the process. We would be interested to hear more about the government's strategy moving forward, including a timeline and a description of the groups who will be involved, identification of those responsible for various aspects of the process, steps necessary to finalize the PRSP and establish a track-record under it prior to the completion point, and whether discussion of proposed triggers for completion point have been vetted with the public. In order to build confidence in the process, we suggest that the final PRSP include a discussion of the various proposals that resulted from the participation process and the extent to which these were incorporated into the PRSP

As part of the PRSP process and as a means to help unleash higher productivity, we think it is important that labor be recognized as an important element in civil society. In this vein, we urge Fund staff to engage the authorities regarding labor issues and ask the authorities to bring the enforcement of its laws into compliance with the ILO core conventions, all of which Honduras has ratified. We understand that the Ministry of Labor is participating in a regional program with the IDB to improve its technical capabilities in the enforcement of labor laws, and while this is a worthy project that merits ongoing support, technical assistance is no substitute for a serious and ongoing process of enforcing labor laws fairly and equitably.

Finally, it is critical that both the authorities and the Fund and Bank begin to work to build a consensus in Honduras for reform. We believe it is essential for the government to articulate to the public the expected benefits of reform, particularly with regard to poverty reduction and structural reform.

Mr. Faini made the following statement:

I can be brief. We support the proposed decision.

On the eligibility of Honduras, we agree with staff assessment that traditional debt relief mechanisms are not sufficient to make Honduras debt sustainable. Incidentally, we are somewhat puzzled by the impact of such mechanisms. Their application in the Honduras case leads to a fall in the NPV of all Paris Club debtors, with the exception of Japan, for which the NPV of debt increases following the application of such relief. Staff clarification on this paradoxical outcome would be welcome. In particular, we would appreciate hearing from staff first why such a paradoxical outcome may arise, and second what its implications are for the computation of total debt relief. Isn't the increase in the NPV of debt for one creditor raising the burden of debt relief for other creditors, including the IMF ?

Again on eligibility, we would note that Honduras would not have been eligible for the initiative if the staff had relied on projected data at the completion point. Clearly, the fact that the new initiative now relies on decision point data rather than completion point data adds a lot to the value of the HIPC initiative. First, it reduces uncertainty about the size of debt relief. Second, it can lead to deeper debt relief and possibly make a country eligible that would not have been eligible otherwise. This is indeed the case for Honduras. Often, NGOs and other critics of the new HIPC Initiative seem to neglect this important aspect.

On the PRSP, we feel that Honduras authorities are making a commendable effort in trying to get civil society to participate in a number of key choices in the fields of education and health. We welcome in particular the attention that will be given to the rights and conditions of minorities and women. We have one question for staff and for Mr. Carstens. From the paper, we learn that the strategy in the education sector will put substantial emphasis on the creation of education committees at a community level. This is a commendable objective, that goes a long way in fostering a participatory process. However, it may be easier to reach in relatively affluent communities. If it is indeed true that non-poor are more likely to get involved than the poor, isn't there a risk that the allocation of funds would privilege relatively well-off communities and penalize poorer households ? Again, staff comments on this issue would be welcome.

Mr. Nelmes made the following statement:

We are in broad agreement with the recommendations outlined in the decision point document, and we share the general views expressed by Mrs. Mateos y Lago and Mr. Weisman in their statements, which raise some interesting detailed questions. I look forward to hearing the staff's answers to those. I would like to make a few brief comments.

First, with respect to eligibility, we agree that the conditions for the decision point have been met. In last year's discussion of the preliminary HIPC document for Honduras, our chair stressed the need for good progress on the PRSP before the decision point, while taking into account the need for flexibility in the timing of the development of the full PRSP. Flexible timing is required, so adequate and broad-based consultations with civil society can be undertaken to ensure ownership in a sustainable poverty reduction strategy. In our view, the Interim PRSP provides a good building block for the full PRSP, and while more work needs to be done, it provides a reasonable basis for moving forward with the decision point. Regarding the participatory process, we welcome the steps outlined in Box 5, and we urge the authorities to broaden and deepen dialogue with civil society as work on developing the full PRSP proceeds.

Second, with respect to interim assistance, we agree that interim relief should be provided, subject to the participation of other creditors. We welcome the authorities' plans that are outlined in paragraph 31 to use interim relief for poverty reduction and social programs, consistent with the proposed HIPC completion point triggers and the PRGF macroeconomic framework. As the staff paper notes, however, for the year 2000, channeling interim assistance to priority areas will require congressional approval of budgetary changes, and I wonder if staff could give us indication of when such changes would be enacted. We also strongly welcome the use of a special poverty fund within the budget to manage resources freed up through debt relief. That is a highly important undertaking that anchors the authorities' commitment to the transparent and efficient use of funds, and we encourage the authorities to finalize the modalities of the fund and to make it operational as quickly as feasible. In this context, I would appreciate if the staff could elaborate on how the transparency of the use of interim assistance will be maintained while the modalities of the fund are being determined and while congress deliberates on the proposed changes to the budget.

Third, regarding the floating completion point, the list of triggers for the completion point makes for a full agenda, but they are necessary for poverty reduction. In particular, I would like to emphasize the importance of preparing, publishing, and implementing a comprehensive anti-corruption plan prior to the completion point. Transparency and good governance are essential for trust in good government, for effective use of aid resources, and

to provide a stable framework in which private sector activity can thrive. We look forward to assessing the anti-corruption strategy.

With these brief comments, we wish the authorities success in the period ahead.

Mr. Zurbrügg made the following statement:

On the issue of the corrections to the decision point document, I agree with the staff representative that they do not change the essence of the decision we are taking today. However, I would recommend that we be very careful in the future, as we are bombarded with a whole series of tables and numbers, and often do not have sufficient time to check if they are correct.

I share the staff's view that Honduras has met the conditions for reaching the decision point under the enhanced HIPC Initiative, and that key benchmarks and performance criteria have been respected, although in some cases belatedly. In view of past experience—before, as well as after Hurricane Mitch—I am confident that the momentum of the reform process will not be lost, and that measures to strengthen governance and transparency, to implement the social security reform action plan, to achieve civil service reform, and to strengthen tax administration will be taken.

The completion point should be considered after one year of implementation of the full PRSP. As the staff rightly mentions, while the Interim PRSP provides a complete diagnosis of the poverty situation, it does not yet contain a comprehensive strategy with detailed actions for poverty reduction. As pointed out by Messrs. Collins and Kelmanson, we should not underestimate the time, effort and resources needed to elaborate a comprehensive, participatory PRSP. While not unduly delaying debt relief, the full PRSP should identify the institutions and processes that will be crucial for its successful implementation.

Turning to the DSA and HIPC assistance, I have three remarks. First, since Honduras is a borderline case in terms of qualifying for the enhanced HIPC Initiative, the impact of the debt relief on the fiscal sustainability indicator is quite small. This comes out clearly in Figure 3 of the correction that was issued yesterday. The NPV debt-to-revenue ratios hardly differ before and after debt relief. What is more disturbing, as mentioned by Mr. Faini, is that starting in the year 2005, the indicators are better before than after debt relief. That is not exactly a selling argument for the HIPC Initiative. I understand that this is mainly due to a Japanese loan that is included in the Paris Club rescheduling, and, if I understood the situation correctly, to the fact that the discount factor is lower than the implicit interest rate that is applied to that particular loan.

Second, regarding HIPC financing, I agree to the participation of the IDB. However, I would like to emphasize that this agreement critically depends on the ability of all participating creditors to effectively come forward with the committed amounts. I also welcome the debt restructuring agreement with CABEL. I hope other institutions will be able to find similar creative solutions, when necessary to ensure effective participation in the enhanced HIPC Initiative.

Third, as already mentioned on the occasion of the preliminary HIPC discussion, I consider, like Mr. Weisman, that some of the DSA macroeconomic assumptions regarding import growth and GDP growth, inter alia, may be too optimistic.

Finally, I would like to comment on the proposed use of HIPC debt relief. As in other countries, the proceeds of debt relief are to be channeled into a special poverty fund. That fund would be included in the budget, but would have a specific governance structure and a substantial share of its activities earmarked for auditing. At the current stage, that is a reasonable solution. However, experience with a poverty action fund in Uganda has shown that a parallel structure can be difficult to administer, that the process of allocation and disbursement of funds can be very slow, and that earmarking can result in a lack of flexibility. In my view, such a fund should remain a temporary measure, and should under no circumstance divert attention away from the urgent need to improve and strengthen the overall budget process.

Mr. Kranen made the following statement:

We thank staff for the well-written and concise document and we support the proposed decision.

Mr. Carstens's preliminary statement has highlighted again the major challenges the Honduran authorities have been facing. We agree with Mr. Morais and other speakers that the authorities have pursued prudent macroeconomic policies. They have resisted the pressures to expand the budget in the aftermath of hurricane Mitch. In light of the recent track-record during the fund supported programs Honduras has shown its ability to meet even high expectations.

Against this background, I would like to confine my remarks to two points:

First. Like Mr. Milleron and Mr. Zurbrugg we also strongly expect that the Electricity Sector Framework law will be discussed and approved by parliament shortly. This would also be a signal of ownership. It should be avoided in any case that this law becomes a kind of dispute in this election year.

Second. Given the mixed progress in poverty reduction over the last years and the fact that two-thirds of the people of Honduras live in poverty, economic growth has to be maintained and its impact on poverty has to be strengthened. We therefore welcome that the main focus of the conditions of the floating completion point are economic growth and poverty reduction. However, these actions have not yet been translated into concrete measures. The Interim-PRSP does not contain these kind of measures which are envisaged for the full PRSP, as Mr. Nelmes and staff pointed out. We hope that the authorities are going to implement these kind of measures as soon as possible in order to reach the completion point soon and to keep the spirit of the Enhanced HIPC Initiative. Against this background let me comment briefly on Mr. Weisman's remarks in the beginning of his statement. From our point of view it is not the preparation of an annual report on implementation of the PRSP which should trigger the completion point. The concept of a floating completion point incorporates more the idea that the determining factor for achieving the completion point should be the achieved progress in the reform agenda.

Finally, I would like to thank Mr. Carstens for his reassuring comments on the strong commitment of the authorities even in this election year. We should not forget, that all the positive effects of the generous support of the International Community will be fading soon if the clear will for further reforms and prudent policy is lacking.

Mr. Mirakhor made the following statement:

Let me first thank the staff for a concise and clear report, Mr. Carstens and Mrs. Del Cid-Bonilla for their comprehensive preliminary statement, and Mr. Carstens for his remarks about the Herculean task of the participatory process in Honduras. Box 5 of the staff paper shows that, in a country with a population of 6.3 million, 6,500 meetings have been held at the municipal level, with an estimated participation of 650,000 people. That means that more than ten percent of the population has been involved in the planning of social programs at the micro level, which is a clear indication of the country's intent and seriousness in dealing with poverty issues. The authorities' sincerity cannot be doubted.

Regarding the issues for discussions raised by the staff, on the first two issues, my answer is in the affirmative. On the third issue, which concerns the completion point, I have some reservations, especially with regard to the issue of ownership and conditionality, and the tensions raised by the set of conditionalities outlined in Section IV of the paper.

First, the staff paper refers to the need for the successful implementation of the full PRSP for at least one year, as evidenced by a comprehensive annual report endorsed by the Boards of the Fund and IDA.

My impression is that this is the first time that the endorsement by both Boards of the implementation report is requested. I am worried about the delays that such a condition may imply. While that condition may have been included in the original decision on the launching of the enhanced HIPC Initiative, I would like the staff to confirm so. Also, in the light of the difficulty of scheduling Board meetings and proceeding with discussions in both institutions, perhaps it would be more efficient and helpful to the country if we incorporated the progress reports on the poverty reduction strategy in the PRGF reviews by the Board of the Fund and in the program reviews by the Board of the Bank.

Second, with respect to the conditionality on the strengthening of the financial sector by application of the Basel Core Principles, while I have no objection to the need to strengthen the financial sector, I do not see the direct relationship to poverty alleviation and the issues of concern in the context of the PRSP. Perhaps it would be preferable to integrate such a conditionality within the PRGF instead.

With these remarks, I wish the Honduran authorities all the best.

Mr. Josz made the following statement:

I agree that Honduras has met the conditions for reaching the decision point under the enhanced HIPC Initiative.

I also agree to the amount and delivery of the assistance, and on the conditions for reaching the completion point, proposed in paragraph 35.

The staff and the authorities are to be commended for their comprehensive strategy for maximizing the benefits of Honduras' HIPC debt relief. I particularly welcome:

The authorities' intention to base the design of their PRSP on consultation with a broad range of interested parties.

The prior commitment of the resources expected from HIPC debt relief to fund additional spending on poverty reduction.

The creation of a Poverty Reduction Support Fund as the first step in creating a transparent channel to direct the resources obtained from HIPC debt relief and privatization receipts to social and poverty reduction programs, and plan to have this fund's operations audited by international accounting firms.

The clear division of labor between the Fund, the World Bank, and the IDB.

I repeat the suggestions for the PRSP that I made at our meeting at the beginning of this month:

Participatory Poverty Assessments, a technique developed by the World Bank to solicit the views of the poor themselves concerning the causes of and remedies for poverty, should be during preparation of the PRSP. Participatory Poverty Assessments have been instrumental in improving policies in many countries. I agree with the proposals of Mr. Collins and Mr. Kelmanson for broadening participation in the design of the PRSP.

The distribution of land should be altered to break the vicious circle of poverty and environmental destruction that results from settling large numbers of smallholders in areas not suited to farming and animal husbandry.

Finally, I support Mr. Weisman's recommendation that national labor laws should be more closely aligned with ILO standards.

Mr. Fidjestol made the following statement:

Since the issues are well covered in the staff paper and by previous speakers, I will be brief and will focus my remarks on the main issues.

I support Honduras' eligibility for debt relief under the enhanced HIPC Initiative. I also agree on the amount of relief under the fiscal criterion.

However, I would like to draw attention to some important challenges for policy mentioned in the staff paper. A high growth rate, set in the paper at 6 percent, is necessary. Initially the growth rate will be supported by reconstruction projects and by recovery in agriculture. Continued growth based on exports and tourism will be more challenging. An important condition for continued high growth is streamlining of the framework for investment by removing bureaucratic impediments.

I would also like to point to the rather weak relationship between economic growth and poverty reduction in Honduras. In order to improve this relationship, increased investment in public sector infrastructure and human capital is needed. More efficient use of this capital is also needed. This should also contribute to a high growth rate.

Implementation of the conditions mentioned under paragraph 19 should contribute to strengthening the relationship between economic growth and poverty reduction and enhance growth. I support these conditions, even though they could have been more oriented toward the outcome of the measures.

I would also stress the importance of broad participation in the development of the full PRSP.

In conclusion, I fully support the proposed decision.

The staff representative from the Western Hemisphere Department indicated that, on the issue of growth projections and whether they were too optimistic, the PRGF-supported program that had been approved three weeks earlier had put special emphasis on additional policies that would boost exports and growth. Also, with a stronger policy framework, improved transparency, and fewer regulations, growth could be expected to increase faster than previously estimated. Changes in the external outlook had also led the staff to consider that the potential for higher growth was strong, particularly following the approval by the U.S. Congress of improved trade benefits which would lead to an increase in maquila exports. In addition, the growth estimates for other trading partners had been revised upwards as well. Exports in 2000 had been growing at a rate of about 18 percent, and were well in line with staff projections, even though they were always subject to risks related to external shocks or adverse weather conditions. Lastly, Table 9 in the staff paper included projections based on lower export growth, which showed that the DSA was not highly sensitive to adverse changes in the external environment.

With regard to the completion point conditions, given the fact that a PRGF and other programs with the Bank and the IDB were already in place, the staff had tried to focus with the authorities on a few issues within areas that were closely linked to poverty—including education, health, and safety nets—in order to define key measures that would help reduce poverty, the staff representative observed. Those measures were not expected to lead to an increase in growth, but were rather perceived as complementary to the policies that were being followed under other programs.

On the question of social security reform, the staff representative indicated that the authorities had approved a clear and feasible plan that they were implementing with the support of the Bank. The increase in the package of basic health services was supported by an IDB project, and the planned increase in the number of beneficiaries in poor communities from 100,000 at the time of the completion point to 250-300,000 over time would benefit from continued international support.

Regarding measures in the financial sector, the staff considered that a properly functioning financial sector could have important implications for growth, investments and access of the poor to credit, the staff representative continued. While the link to poverty reduction was indirect, those measures were nonetheless essential, especially considering the negative impact previous financial crises had had on the poor.

Mr. Mirakhor, while he agreed that the strengthening of the financial sector was necessary to improve growth prospects, wondered whether such a conditionality would not have been more appropriate in the context of the PRGF.

The staff representative from the Western Hemisphere Department responded that financial sector reform measures were already included in the PRGF-supported program, and

that the measures that were being proposed as completion point triggers under the enhanced HIPC Initiative should be seen as complementary efforts. With regard to the feasibility and the monitoring of conditions related to the strengthening of the financial sector, including, specifically, raising the capital adequacy ratio from 9 to 10 percent, the staff and the authorities considered that this should not be problematic, because there were currently only six banks that did not meet that criterion, and five of them were expected to have done so by end-2000. On the application of the Basel Core Principles, the implementation of that condition would be facilitated by the fact that an assessment under the Fund/Bank Financial Sector Assessment Program would be carried out in 2001.

With regard to the participatory process, the staff representative pointed out that the timetable for the preparation and implementation of the PRSP was described in Appendix II of the staff paper, with the second round of consultation at the national level between the authorities and civil society starting in July 2000. The civil society participants were listed in the Interim PRSP.

In response to questions on the poverty fund, the staff representative indicated that it was still in the process of being set up, and that discussions with the authorities on its modalities of operation were under way. A council to oversee the fund would be established, and would include the minister of finance, two other members from the government appointed by the president, as well as a representative appointed by the private sector and other civil society interest groups.

Discussions on social spending priorities and the medium-term expenditure framework were also under way, and they would be closely examined in the context of the PRSP process, the staff representative indicated. Directors' views on the need to increase social spending would be conveyed to the authorities.

The staff representative from the Policy Development and Review Department, in response to Mr. Faini's and Mr. Zurbrugg's question on the increase of the NPV of the debt owed to Japan following the application of traditional debt relief, indicated that this was due to certain uniform assumptions the DSA was based on regarding future streams of payments and how to discount them to their net present value. There were two aspects to the phenomenon identified. One, the average original interest on Japanese loans to Honduras was 8-9 percent for non-ODA loans and 3 ½ percent for ODA loans. These rates exceeded the current OECD commercial interest reference rate that was used for discounting, 1.98 percent, which reflected current market rates. Consequently, the NPV value of the debt to Japan exceeded the nominal value. Two, in calculating debt after traditional debt relief, the DSA assumed all ODA debt would be rescheduled at the original interest rate with a sixteen-year grace period and a forty year maturity. This stretching of maturities, given that the interest rate is above the discount rate, resulted in an increase in the NPV value. Nevertheless, it had to be borne in mind that this rescheduling assumption was not necessarily realistic, and that where original interest rates on ODA loans were above current market rates, they were likely to be subject to renegotiation.

Mr. Faini wondered what the implications for the overall delivery of debt relief would be if the assumptions of the DSA remained unchanged, his understanding being that debt relief to reach a certain NPV would need to increase for certain creditors, including the Fund.

The staff representative from the Policy Development and Review Department indicated that, with regard to the question raised by Mr. Mirakhor concerning the necessity of implementing satisfactorily the full PRSP for one year, this was clearly spelled out in the decision to amend the PRGF-HIPC Trust Instrument (EBS/00/9, 1/20/00).

Mr. Kranen remarked that there had been a long discussion on that same issue in the case of Tanzania, and that, as no agreement had been reached by the Board, it had been decided to reexamine the issue at a later date.

The Acting Secretary indicated that the summing up of the Board meeting on Tanzania stated that "While Directors agreed that these conditions should include endorsement by the Fund and Bank Boards of the PRSP and of the authorities' first annual report on the implementation of their poverty reduction strategy, many Directors urged that the latter condition be interpreted flexibly so that it would not unduly lengthen the period between the decision and the completion points." The main concern of the Board was therefore that the implementation of the poverty reduction strategy should be adequate.

Mr. Nelmes asked the staff when congress would approve the budgetary changes that were necessary to incorporate the use of interim assistance into the budget.

The staff representative from the Western Hemisphere Department responded that, while it was difficult to predict parliamentary processes, the staff anticipated that once the poverty fund had been established and the interim assistance was forthcoming, the authorities would present the budgetary changes to congress, which could be approved rapidly, as they were not likely to be controversial.

Mr. Zurbrugg expressed his surprise at the fact that some countries used refinancing rates that apparently were substantially above the commercial interest rate that was being used as a discount rate. That was a fact that was difficult to accept in the context of the enhanced HIPC Initiative.

Mr. Hinata made the following statement:

At this stage of discussion, I will be very brief. I welcome the economic improvements achieved under the PRGF-supported program, and encourage the authorities to keep the program on track and further strengthen macroeconomic management. While I agree that the conditions to reach the decision point under the enhanced HIPC Initiative have been met, the delays in the implementation of structural reforms are regrettable. I would like to repeat the importance of further efforts in that area in order to achieve sustainable economic growth in the medium-term.

Regarding the interim assistance, given the necessity of improving social policies in order to reduce current poverty levels, I am prepared to support the staff's recommendation to provide interim assistance between the decision and floating completion points.

With respect to the floating completion point, the conditions outlined in the staff paper appropriately include achievements such as the successful implementation of the full PRSP for at least one year, and the endorsement by the Boards of the Fund and Bank of the first annual comprehensive report. I encourage the authorities to maintain the momentum of their efforts to prepare the full PRSP and to make further progress in implementing economic reforms so as to reach the completion point in accordance with their timetable.

With these remarks, I support the proposed decision.

Mr. Borpujari made the following statement:

This chair is already on record with support for relief to Honduras under the Enhanced HIPC Initiative. I will therefore only make brief remarks on issues in the proposed decision.

I agree that the adjustment and reform effort of recent years qualifies Honduras as meeting the requirements for reaching the Decision Point under the Enhanced HIPC Initiative. I also endorse provision of interim assistance between the decision and the floating completion point.

I broadly agree with the conditions laid out in Section IV for reaching the completion point. As staff notes in paragraph 20 and Box 5, these conditions correspond to policy priorities that the authorities have already set within the agreed framework of the Enhanced HIPC. Here, it is important to stress that the agreed policy goals, while achievable, are also ambitious. Flexibility in implementation of the strategy is, therefore, important.

While I have the floor, I also wish to associate myself with the views of Mr. Carstens and others on the need of a strategy for dealing with NGOs. The Fund's legitimacy is fully transparent and a matter of the public record. The need now is of a principle of correspondence so that we are in a position to make a similar claim on behalf of our interlocutors.

With these remarks, I wish the authorities further success.

Mr. Hendrick made the following statement:

At the outset, I would like to support the proposed decision and congratulate the Honduran authorities for their progress in the structural reforms and the privatization program. As we expressed in the previous

Board meeting, at the time of the second review of the PRGF arrangement, the authorities' strong commitment to sound macroeconomic management and reform has, so far, been unquestionable. However, as Mr. Carstens and Mrs. Del Cid-Bonilla indicate in their preliminary statement, Honduras' social indicators are still among the weakest of the region, with poverty affecting about two-thirds of the population.

Now it is the time for the Fund and other multilateral financial institutions to follow the example set by the Central American Bank for Economic Integration, which was the first multilateral bank in securing debt relief for Honduras despite their financial constraints.

On the issues for discussion raised by the staff, I agree that Honduras has met the conditions for reaching the decision point under the Enhanced HIPC Initiative and I also endorse the staff recommendation of providing interim assistance between the decision and the floating completion point. Honduras not only need but also deserve this financial support.

On the conditions for the floating completion point, I find appropriate the triggers described in section IV of the document. Nevertheless, I would like some clarification on the trigger related to a "substantive application of the Basel Core Principles to the banking sector". Although staffs are aware that this assessment requires qualitative judgement, I wonder whether there is no other objective ways to monitor progress in this area. In this regard, like Mr. Mirakhor, I also think that the proper place for conditionality in the financial sector is the PRGF arrangement and not a condition for a completion point on poverty issues.

I share Mr. Carstens' view about the participatory process and the role of the civil society in building the full PRSP. As Mr. Faini has pointed out, the government has to have a leading role in the consultation process.

In relation to the trigger for the implementation of social investment projects based on participatory planning methodologies in all beneficiary municipalities, I agree with Mr. Milleron and Ms. Mateos and Lagos that the ideal scenario would be that all projects meet those characteristics. However, this could not be practical. The authorities have to strike a right balance between implementation time and a broad participatory process for every project.

Finally, I welcome the authorities' decision to establish a poverty reduction support fund to increase the efficiency and transparency in the use of the funds released from debt relief and the privatization proceeds to the assigned social programs.

With these remarks, I wish the Honduran authorities well in their challenging endeavors ahead.

Mr. Houtman made the following statement:

I strongly support the proposed decision. For the sake of brevity, I would like to associate myself with the views expressed by Mr. Nelmes, Mr. Zurbrugg, and Mr. Weisman, as well as the views expressed Mr. Milleron and Mr. Collins in their preliminary statements, especially on the issue of the participatory process.

The staff representative from the World Bank indicated that the conditions for the completion point had been arrived at in consultation with the authorities, part of civil society, the IDB, and the Fund. With regard to the anti-corruption strategy, the Board of the Bank had recommended to go beyond the reform of procurement practices and strengthening the control of regulatory agencies, and to move toward a broader, fully participatory anti-corruption program. The social security reform plan was crucial, both for the social security system and for the health sector. In that respect, it was important to underscore that social security and health needed to be considered separately, which had not been the case so far. Regarding the pension system, reform efforts were directed at improving coverage and ensuring sustainability over the medium-term. In the area of health, despite the considerable progress made recently, one of the key weaknesses remained maternal mortality. The rates were very high, even taking into account the country's low-income status. Also, there were large gaps in coverage, with 25 percent of the population still not covered by the health system. The IDB had therefore designed a basic package of services, including a package geared specifically toward mothers.

In response to the question on the impact of the creation of education committees, and whether higher income communities would be better prepared to take advantage of such an initiative, the staff representative explained that the experience from other countries in Central America—notably, in El Salvador and Guatemala—had been exactly the opposite, and that the best results had been achieved in the poorest communities which had the most to gain from adapting the education of their children to their specific needs and circumstances.

The Honduran Social Investment Fund (FHIS) was the key element of the social protection network in the country, and the assessment of the Bank's staff was that it was a highly effective instrument, the staff representative continued. The one weakness of the FHIS was the insufficient level of participation, and that was why the strengthening of community participation, including in the design and the choice of projects, had been identified as a condition for the completion point.

The strengthening of the financial sector was critical to avoid any potential crisis which could have a negative fiscal impact and ultimately lead to an increase in poverty, the staff representative remarked. The Country Assistance Strategy (CAS) for 1999-2002, which had been discussed by the Board of the Bank in December 1999, reflected all those issues,

and explained in greater detail why they were priorities. The CAS had been prepared in a fully participatory manner.

Mr. Carstens thanked Directors for their views, which would be conveyed to his authorities. It was necessary to emphasize that the PRSP was a work in progress, and that the participatory processes would be strengthened during the course of the preparation of the full PRSP. The recent creation of a national statistics office would also be useful to provide valuable information on the relationship between the poverty reduction and economic growth in the country.

On the issue of the speed of privatization and structural reforms, Mr. Carstens remarked that one should consider the overall track record of Honduras and the considerable amount of reforms the authorities had implemented in a brief period of time. It was also worth bearing in mind that certain delays related to the legislative branch of government could not easily be avoided. In addition, an appropriate balance had to be found between the speed and the quality of legislation. With regard to the strengthening of the financial sector, the authorities were aware of the importance of that matter and were fully committed to addressing it.

The question raised by Mr. Faini on the impact of the creation of education committees at the community level was important, Mr. Carstens continued. Often, in countries of the region, the educational system was highly centralized, with strong unions, and the reality of communities was completely lost. This had led to significant problems of absenteeism and insufficiently qualified or even inapt teachers. The involvement of the community was essential, not only to determine the school curriculum, but also to choose teachers on the basis of their skills and their character, especially given their prominent role in society and, in particular, in smaller communities. Therefore, in spite of the concerns raised by Mr. Faini, the experiment was worthwhile conducting and was likely to be beneficial.

The Acting Chairman made the following summing up:

Directors agreed that Honduras has established a credible track record of good performance in implementing a comprehensive program of macroeconomic, structural, and social reforms, and they supported the thrust of the economic program for 2000-02, which is supported by an arrangement under the Poverty Reduction and Growth Facility (PRGF). They therefore agreed that Honduras is eligible and qualifies for debt relief under the enhanced HIPC Initiative, and that the interim Poverty Reduction Strategy Paper (PRSP) provides a satisfactory basis for reaching the decision point now.

Directors also agreed that the fiscal criterion should be used to calculate the reduction of the NPV debt, and supported the staff proposals for the amount and delivery of assistance, which are aimed at making Honduras's debt burden sustainable. To help Honduras achieve the external debt

sustainability target of 110 percent of NPV of debt to exports, which results in a reduction of the present value of the debt-to-revenue ratio to 250 percent, Directors agreed that the IMF would make available to Honduras total assistance amounting to the SDR equivalent, at the decision point, of U.S.\$30.3 million in the form of a grant at the completion point. To accelerate the provision of debt relief and to free resources for urgent poverty programs, Directors endorsed the staff proposal that the decision on the Fund's commitment of interim financial assistance be approved on a lapse-of-time basis, once satisfactory assurances from creditors representing 80 percent of Honduran external debt are received concerning their commitment of resources, as required under the PRGF-HIPC Trust instrument. Directors noted that there will be a continued need for large amounts of highly concessional international assistance from multilateral and bilateral donors to supplement the resources arising from debt relief under the enhanced HIPC Initiative.

Directors agreed that the floating completion point for Honduras would be triggered by the conditions contained in paragraph 19 of the HIPC Decision Point Document (EBS/00/114, 6/20/00), including the maintenance of sound macroeconomic policies (as evidenced by a satisfactory performance under the program supported by the PRGF arrangement) and the successful implementation of the identified structural reform measures. In particular, they welcomed the focus on transparency, governance, and poverty and social programs. Directors stressed the particular importance of monitoring progress in the period leading up to the completion point. Directors agreed that, as a condition for reaching the completion point, the authorities will also need to have prepared a full PRSP, and satisfactorily implemented their poverty reduction strategy for at least one year. Directors encouraged the authorities to broaden and deepen the participatory process in the preparation of the full PRSP.

The authorities were encouraged to apply the resources freed by debt relief under the enhanced HIPC Initiative to poverty and social objectives, in a transparent and efficient manner. In this connection, Directors welcomed the establishment of a Poverty Reduction Support Fund to administer the proceeds of debt relief, targeting assistance to vulnerable groups; they also supported the intention to include it in the annual budget, although this should not detract from the broader objective of strengthening the budget process.

The Executive Board took the following decision:

1. Based upon the debt sustainability analysis for Honduras (EBS/00/114), the Fund, as Trustee (the "Trustee") of the Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations ("Trust") established by Decision No. 11436-(97/10), adopted February 4, 1997, decides that:

(i) in accordance with Section III, paragraphs 1 and 2 of the Instrument, Honduras is eligible and qualifies for assistance under the enhanced HIPC Initiative pursuant to the terms of the Instrument;

(ii) the completion point for Honduras shall be reached on the date when the Trustee determines that:

(a) Honduras has satisfactorily implemented the structural measures described in paragraph 19 of EBS/00/114;

(b) Honduras has a stable macroeconomic position and has kept on track with its Fund-supported program; and

(c) Honduras has prepared a Poverty Reduction Strategy Paper and has satisfactorily implemented its poverty reduction strategy for at least one year;

(iii) the external debt sustainability target for Honduras is 110 percent for the present value of debt-to-exports ratio, which results in a reduction of the present value of debt-to-revenue ratio to 250 percent;

(iv) in accordance with Section III, paragraphs 3(a) and 3(b) of the Instrument, the SDR equivalent of US\$30.30 million of assistance will be made available by the Trustee to Honduras in the form of a grant to permit a reduction in the net present value of debt owed by Honduras to the Fund, subject to satisfactory assurances regarding the exceptional assistance to be provided under the enhanced HIPC Initiative by Honduras' other creditors; and

(v) in accordance with Section III, paragraph 3(e) of the Instrument, the Trustee shall disburse the assistance committed to Honduras under paragraph (iv) of this decision at the completion point, together with interest on the amount committed, calculated at the average rate of return per annum on investment of the resources held by or for the benefit of the Trust. (EBS/00/114, Sup. 1, 6/27/00)

Decision No. 12223-(00/65), adopted
June 30, 2000

3. PANAMA—STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on Panama's request for a Stand-By Arrangement (EBS/00/107, 6/14/00; Cor. 1, 6/29/00; and Cor. 2, 7/11/00).

The staff representative from the Western Hemisphere Department made the following statement:

The following information has become available since EBS/00/107 was issued, which does not alter the thrust of the staff appraisal.

Legislation modifying the law that created the Trust Fund for Development (TFD) was mailed on June 28. As anticipated in EBS/00/107, the modified law permits up to 20 percent of the TFD's assets to be used to repurchase Panama's external debt. In addition, the law allows the TFD's assets to be invested in various domestic and foreign financial instruments: (i) term deposits in national and international banks with an investment grade rating; (ii) investment-grade mortgage bonds; (iii) investment-grade corporate debt; (iv) bonds issued by multilateral lending agencies; (v) bonds issued by the Panama Canal Authority; and (vi) international bond funds. Apart from term deposits, only 20 percent of total TFD assets can be invested in any one category.

The diversification permitted by the modified law is expected to increase the average rate of return on the TFD's investment portfolio. The TFD's income—projected at US\$559 million (about 5.5 percent of projected 2000 GDP) between 2001 and 2004—will be earmarked for expenditures on economic and social development programs, particularly in the areas of agriculture, education, transport, health services, and the judicial system.

The Superintendency of Banks approved the regulations governing asset quality and provisioning, which completes the banking regulatory framework envisaged under the EFF program (1997-2000).

The 12-month increase in consumer prices was 1.6 percent in May 2000. The annual increase in net exports of the Colon Free Zone was 11 percent in the first quarter of 2000, with exports rising by 9.2 percent and imports by 8.8 percent.

Mr. Portugal and Mr. Macia made the following statement:

On behalf of our Panamanian authorities, we would like to convey their appreciation for the policy advice received from the Fund and for the dedication shown by the staff during the discussions leading to this stand-by request.

Given its generally prudent and conservative macroeconomic policies and the substantial structural reforms it has undertaken, Panama has enjoyed steady economic growth and low inflation for a decade now. However, the benefits of this positive macro-economic performance have been slow to reach

a substantial proportion of the Panamanian population. The share of the population living below the poverty line (37 percent) and of those living under extreme poverty (19 percent) are large given the country's per capita income level. Hence, the basic objectives of the new administration –that took office in September last year– are to persevere on the path of prudent macro-economic policy and structural reforms and to take additional actions to ensure that the benefits from economic growth are more equally distributed. The precautionary stand-by arrangement they are requesting, by focusing on fiscal consolidation and on additional structural measures, will help to address important challenges in pursuing these twin objectives.

With two exceptions, Panama's performance remained fairly on track under the previous extended arrangement with the Fund. Real growth in 1999 at 3.2 percent of GDP was lower than the program's projection of 4.1 percent mainly due to depressed external demand. But the unemployment rate was reduced from 13.5 percent to 11.6 percent. Inflation remained subdued despite increased international oil prices. While fiscal performance went off-track in 1998 with an overall PSBR of 2.9 percent of GDP owing to additional expenditures and investment overruns allowed by the previous administration, the expenditure restraint imposed in 1999 managed to reduce the fiscal deficit to 1.4 percent of GDP, compared to a program target of 1 percent. The external current account deficit was the other area where the previous program projections did not materialize. The substantial increase in the current account deficit in 1998 and 1999 was due partly to the high levels of investment associated with the devolution of the Canal Area and with the decline in export activity in the Colon Free Zone due to lower external demand.

The new SBA envisages a deepening of the fiscal consolidation effort that was started in 1999 by the new administration. The authorities intend to further reduce the fiscal deficit to 1 percent of GDP this year through a reduction in current expenditures and a cut of almost 40 percent on central government's budgeted investments. Indeed, thanks to their prudent fiscal management, the fiscal accounts showed a small surplus in the first quarter of 2000.

The authorities also aim to eliminate the fiscal deficit as from 2001 by proposing legislation to expand the VAT tax-base, by increasing taxes on banks' income, by curtailing drastically tax exemption and preferences and by maintaining expenditure restraint, while protecting well-targeted social expenditures. To help control public expenditures better, the authorities will extend the scope and coverage of their automated financial management system (SIAFPA), which is now under the direct control of the Ministry of Economics and Finance, to cover all central government institutions and agencies and to monitor some types of expenditures that are currently outside the system, thus reinforcing the Treasurer's operations. Real-time expenditure control under the SIAFPA is expected to be fully operational within the

central government in the next 18 months. The authorities' fiscal program, together with the expected GDP growth, will allow for a substantial reduction in net public debt to about 37 percent of GDP by end-2004 from its 50.2 percent level at end-1999.

The authorities also intend to proceed with implementation of a structural reform agenda that, in addition to the structural fiscal measures already mentioned, will encompass actions in the areas of social security, the financial sector, and non-financial public enterprises.

On social security, collections have improved since the enactment of Law No. 20, in December 1999, and almost 1500 companies have come forward to subscribe to the system, which will represent additional contributions of over US\$5.1 million. But despite the present cash-flow surpluses, the government is concerned that with the aging of the population, the system might run into deficits within a decade. Hence, the authorities want to take preemptive action and will appoint a high level commission to analyze the recommendations of an ILO's study on financial and actuarial issues related to the social security system. The alternatives proposed will be broadly consulted before being gradually phased in.

On the financial sector, legislation to close down the mortgage bank (BHN) will be presented to the legislature by end-2000. The agricultural bank (BDA), with a portfolio of US\$83 million in outstanding loans, of which about 31 percent are considered non-performing, will be subject to an external audit to be concluded in October 2000. Restructuring will follow and its loan activities will be directed to small farmers.

The financial sector regulations and supervision have been strengthened substantially with the creation of the new Superintendency of Banks. Progress has been made in the implementation of the Basle Core Principles for Effective Banking Supervision bringing the system closer to international standards. New regulations have been introduced for stock market operations and for insurance companies. The Superintendency has acted to enforce capital adequacy and liquidity requirements, uniform accounting standards, and reporting standards according to the Basle principles. It also aims to audit one-third of the banks by end-2000, and all banks by end-2001. Additional resources will be allocated to upgrade the Superintendency's human and technical capabilities. The auditor corps will benefit from technical assistance requested to the Federal Reserve and the Bank of Spain.

Since 1991 Panama has a bilateral agreement with the United States (Law No. 20 of July 22, 1991) for mutual assistance on investigations, suppression, and indictment of drug trafficking and related money laundering activities. The Panamanian legislation requires the registration, reporting, and

control of any transactions over B. 10,000 (equivalent to US\$10,000). Compliance officers in each bank must report suspicious transactions to the Financial Analysis Unit of the Superintendency of Banks, which then reports such activities to the Office of the Attorney General for review and action. There are no legal obstacles for providing foreign judicial authorities with information on such transactions once a criminal investigation is under way in the requesting country. Our Panamanian authorities are determined to strengthen their legislation to keep pace with the continuous expansion of money laundering in the world. Last May, President Moscoso made a speech announcing that Panama would start a study to extend money laundering legislation to funds originating from criminal activities other than drug trafficking such as corruption, illicit enrichment, arms traffic and other crimes. A commission for that purpose has already been established.

Panama has undertaken an important privatization program that has transferred to the private sector most state-owned non-financial enterprises. The government intends to continue the process of divestiture or rationalization of its remaining enterprises. Initial steps for the concession of the administration of Tocumen Airport will be started, and a bid to award the concession to a private operator is expected to be completed within the next 12 months. The water and sewer utility (IDAAN) will be restructured to enhance its management, and some of its services such as billing, collections, and metering, as well as the expansion of water services, will be subcontracted to the private sector. At this moment, metering of water consumption covers only 43 percent of the metropolitan area. It is expected that under a restructured management, metering will be expanded, collections improved, and the tariff structure modified so as to bring IDAAN back to a profitable stance.

As we mentioned before, a high poverty incidence remains one of the government's major concerns, and it will be tackled on various fronts. The problem is especially acute in indigenous and rural areas. Poverty affects about 95 percent of the residents of indigenous areas, where 86 percent live in extreme poverty, and every second child is malnourished. The newly approved TFD bill will allow the allocation of over US\$550 million in fund's interest yield to social programs in the next four years. Immediate actions to increase resource allocations to key poverty actions will target land titling, basic health services, basic education, housing for the poor, and access to potable water. A "poverty map" prepared with the assistance of the World Bank in 1999 is being used for the purpose of these allocations. Land titling programs under the support of the World Bank and the IDB aim to benefit over 200,000 small farmers in rural and semi-rural areas between 2001 to 2004. Rural communities will also benefit from a "Sustainable Farm Program" with a total of 3,000 farms being reached by end-2004. The program targets farm sizes of 5 hectares in average, and about 15 participating

families per farm. Total investment in this program is expected to reach over US\$75 million by 2004.

Our authorities welcome the staff's recommendation for technical assistance to further improve the national accounts and the balance of payments statistics and look forward to the Funds' technical assistance to the Directorate of Statistics to implement the accounting of transactions, and asset valuation and recording of the transferred properties from the Panama Canal Area.

With the implementation of this program the authorities anticipate that economic growth, which is expected to reach 3.8 percent in 2000, will increase to 4.5 percent in 2001, and to 5 percent thereafter. A rebound in agricultural and services exports is envisaged, as well as an increase in the free zone re-export activities. Unemployment should be reduced to about 11 percent by 2001 as economic growth prospects improve. The external current account deficit should be reduced to about 9.2 percent of GDP in 2000, and come down further to about 6.8 percent of GDP for 2001.

Our authorities are committed to implement the economic and financial measures of this program, as well as to direct resources to well-targeted poverty reduction programs to benefit the neediest in the population.

Mr. Portugal added that the government had strengthened financial sector supervision, and was developing strengthened legislation to combat money laundering. In today's Financial Times the bank superintendent had announced that she expected the new laws to be drawn up by July 31.

Mr. Oyarzabal made the following statement:

I would like to commend the staff for a comprehensive paper on the request for a Stand-By Arrangement by Panama. As we stated in our discussion of last February's Art. IV Consultation, one can appreciate the positive results obtained by the authorities in the recent past in maintaining inflation at relatively low levels, addressing fiscal discipline and implementing initiatives for structural reforms. Nevertheless, vulnerabilities still remain that would require that the authorities stay their course and strengthen their actions in all of the areas where initiatives have already been taken.

We coincide with staff in recognizing the significance of the commitment to gradually reduce to zero public sector borrowing, and also to ensure that initiatives on social policies are handled in an adequate financial manner. As staff states, this is a sign of determination to further consolidate public finances. Those actions that can be taken by the authorities directly without the need for legislative approval should be accelerated. From the

paper one identifies the need for strict control on the release of budget allocations and the resulting expenditure commitments, and the upgrading of the SIAFPA system. Measures that have to be approved by the National Assembly must be evaluated for their timely implementation. The recent support of the Assembly with respect to the trust fund creates a positive image of the working relationship between the Executive and the National Assembly. I would request from the staff some information as to what measures to strengthen the fiscal account would require approval of the National Assembly and if they can envisage their approval in an adequate timeframe. It would seem that the possibility of reducing exemption of the VAT, as well as other preferences and exemptions affecting income tax, as well as the approval of budgetary allocations for tax administration into year 2001 could be considered part of the package that must receive legislative approval.

The Social Security System, which clearly requires the need for social consensus, is an area, which needs pre-emptive action. We certainly hope that the high level commission to be established to address the possible reforms to increase collections for the system produces results in a timely manner.

The aim of the government to address the difficulties that have arisen from the lack of efficiency, the subsidized loans, and the target of the lending policies of the BHN and the BDA should be accelerated. It would be a good signal to the market of the reform efforts of the authorities.

We welcome the initiatives already taken by the authorities towards the establishment of the Superintendency of Banks, and would encourage the authorities not to lose momentum in implementing regulations to strengthen the regulatory framework that will be instrumental in creating an adequate capacity for bank supervision. The level of capital adequacy ratios appears to respond in a very responsible manner to avoid increased banking risks. Also, the aim to audit all banks by the end of 2001 should prove fruitful to the system as a whole. As more resources are allocated to the Superintendency, it will fortify its regulatory capacity.

We share the staff's view that efforts to increase expenditures for primary education and health care should have very beneficial results for the most needy. The programs assisted by the World Bank appear to be well targeted, not only with respect to the population but also geographically, as these are being executed in regions with the greatest need.

Taking into account that the ZLC is benefiting from the recovery of its existing markets, improved port facilities, and sizable investments in storage and transport facilities, the competitive export potential is certainly strengthened. Nevertheless, authorities should be vigilant of the developments in commodity prices, international interest rates, and the economic

performance of Panama's trading markets to be able to meet the optimistic projections for exports and the decline of the current account deficit. They should be prepared to take immediate action in case unexpected circumstances develop.

As the authorities appear to be committed to public sector consolidation, to continue structural reform efforts, to strengthen financial sector supervision, to increase export competitiveness, and to addressing social concerns, we support their request for the Stand-By arrangement, and wish the authorities success in their future endeavors.

Mr. Faini made the following statement:

Recent macroeconomic developments in Panama are broadly encouraging. The proposed program focuses, quite appropriately, on the continuation of structural reforms and on fiscal consolidation. The emphasis on fiscal retrenchment is warranted. Despite the absence of any exchange rate risk, Panama's spread on its sovereign debt has been persistently high. It now stands at 466 bb, showing that market confidence is at best shaky and needs to be strengthened. Fiscal rectitude is essential to enhance the credibility of the policy commitment of the new government.

When mentioning the credibility of the government's commitment, we should recall that Panama holds the dubious privilege of being the country that has received the highest number of IMF programs. Between 1973 and 1997, Panama received 13 arrangements, ranking in this contest head to head with Pakistan and ahead of all other members. Moreover, many of these arrangements have gone off-track, including the last stand-by that was left to expire in 1998. In the recent discussion on Fund facilities, many Chairs expressed concern about repeated use of Fund resources. We have here a case in point. We understand that this is a new administration. We are also aware that the Fund does not yet have a clearly defined policy for repeat users. However, we still believe that the Board should take a very close look at those countries that keep returning to the Fund, particularly if they do not seem to make significant inroads on the way to macroeconomic stabilization and structural reforms.

Let me turn therefore to a number of questions about the program.

Does Panama need a program? The answer is yes. The current account deficit is astonishingly large, fueled by fast credit growth as well, and is a source of concern despite the fact that it originates largely in the private sector. More crucially, the significant interest rate premium paid by the country points to widespread market questions about the external financial viability.

Should the program be strengthened? The answer is yes, again. First, in very general terms, Panama's abysmal track record means that nothing less than a highly ambitious program is required to buttress market confidence. Second, Panama's economy is hampered by substantive weaknesses:

Financial sector regulation and supervision. The quality of financial supervision and the transparency of financial institutions have been repeatedly questioned, in many fora. We welcome the fact that, somewhat belatedly, banking supervision has become part of Panama's institutional landscape. Mr. Portugal's provides many useful details in this respect. We note in particular that the program envisages, among the structural benchmarks, that the Superintendency carry out audits of 30 percent of the banks as well as a self assessment of its own performance. Both tasks, which have to be completed by end-December, are certainly an important first step, but are clearly insufficient to provide us with the comprehensive assessment of Panama's banking and financial sector soundness that is indeed called for. We feel, in particular, that the available information on the ability of the new supervisory authority to access the accounts of on-shore and off-shore institutions and, in general, to perform consolidated supervision is highly inadequate. We are also concerned about the activity of non-banking financial institutions. Weak regulations in this area will exacerbate the lack of transparency and the potential for financial instability. Unquestionably, the IMF must make its own assessment of many of these issues, which have a bearing on its core areas. Against this background, we think that Panama would greatly benefit from a Basle Core Principles Assessment (CPA) by the Fund, preferably in the context of an FSAP. Such assessments would also serve to determine Panama's needs for technical assistance in this field, which we would certainly support. Staff comments would be welcome.

Financial sector restructuring. The program aims at liquidating the Mortgage Bank but would allow the Agricultural Development Bank to survive. The latter has failed so far to provide credit to those who need it most: small poor farmers that constitute the bulk of Panama's poor. We are not given much detail on the plan to rationalize the BDA and ensure that its operations benefit small farmers. We are concerned that under these circumstances continuing operation of the BDA would keep favoring less deserving groups. This would be unfortunate. Panama has one of the most highly unequal income distributions in the world, with the poorest 10 percent of the population receiving only 0.7 percent of total income.

Trade liberalization. Panama's record in the field of trade liberalization is less than impeccable. In the early nineties, Panama ranked very high on the Fund trade restrictiveness indicator. The stand-by arrangement in the mid-nineties did little to improve the situation despite substantial commitments to this effect by Panamanian authorities. It was only with the accession to the WTO that Panama made some significant steps toward a more liberal trade

regime. Many of these steps however, particularly in the agricultural sector, were all but reversed. We learn that it will take four years for protection to return to its 1999 level. This does not seem to us an ambitious target. Yet, the staff paper appears to condone both the policy reversal and the slow pace for dismantling the newly imposed restrictions. Overall, in the past, the Fund does not seem to have been extremely effective in fostering trade liberalization. In addition, its reaction to what is indeed a major backtracking with respect to Panama's steps toward a more liberal trade regime cannot be described as very forceful.

Public sector. We welcome the planned strengthening of fiscal consolidation, but we would like to have more information on the public debt and its relations with the non-budgetary institutions and state-owned banks.

To sum up, Panama needs a comprehensive and ambitious program both to stabilize its economy and to create the conditions for rapid and sustained growth. Inefficiencies in resource use are pervasive, as demonstrated for instance by the large imbalance between the investment rate, which averaged 27.2 percent during the nineties, and growth, which hovered around a comparatively modest rate of 4.2 percent. The implicitly high level of the incremental capital output ratio, which averaged 6.2 between 1990 and 1998, and reached 8.3 in the last two years, is a testimony to the need for a forceful program of structural reforms. Failure to deliver on agreed upon commitments may severely unsettle market sentiments. Moreover, the program will need to be strengthened, particularly in the area of financial regulation and supervision, before the next review.

Mr. Bauche made the following statement:

When we discussed Panama last February, on the occasion of the article IV consultation, Staff flagged the possibility that they would soon be coming back to the Board with a request for a stand-by arrangement. At that time, we were not convinced that a new Fund program was warranted, but we stated clearly our view that "if it appear(ed), later on, that Fund support (was) indeed called for, then we would expect to find in the Staff report something that we were disappointed not to find in (the) article IV report, namely a presentation of the shortcomings of Panama's legislation with respect to the prevention of illegal financial activities and of the authorities' moves to upgrade this legislation, increase the transparency of financial operations performed locally and take a more active part in international cooperation efforts."

Most unfortunately, these points are not addressed at all in the report before us.

But, as we are all aware, international circumstances have evolved since February. And what might have then appeared to be a relatively isolated concern, is today powerfully vindicated by the recent publication of two lists issued by two prominent components of the international financial architecture, namely the Financial Stability Forum and the Financial Action Task Force.

Against that background, we find it not just odd or awkward, but simply unacceptable, that the paper submitted for our approval today falls short of addressing these issues. We may not have decided yet on what the Fund's policy toward off-shore centers should be. But we know for sure that we want the Fund to be at the center of the new international architecture, which means that this institution cannot continue to ignore the growing unease in the international community concerning prudential supervision and illegal or unscrupulous activities. This is why the IMFC has welcomed the work done by the FSF, and has asked the Board to consider the FSF request that the IMF take responsibility for developing, organizing and carrying out an assessment process for OFCs.

Obviously, the matter would have been clearer if the consideration of this request for a stand-by arrangement had been postponed until after our policy discussions on the issue—only a few days from now.

As things stand, however, the Board is in the uncomfortable position of considering a program for a country featuring prominently on two international blacklists, without addressing that issue.

We are firmly convinced that approving the program as it stands now would be highly detrimental.

First, because it would constitute a reputational issue for the credibility of the Fund's leadership in financial reform. Granting the Fund's seal of approval to countries singled out by other fora without addressing the reasons would:

give the public legitimate grounds to question the seriousness of our commitment to fight international financial criminality,

and, even worse, could give the sentiment that the IMF is a tacit accomplice of a wall of silence, undermining our efforts to increase our transparency and responsiveness to potential threats to financial stability ;

Second, because approving the program as it now stands, when all market participants have the FSF and FATF lists in mind, could create a precedent which will undermine our line of action for the future. It may be argued that "In supporting Panama's request for a Stand-By Arrangement, we

must clearly state that the issue of money laundering has not been a policy element to be taken into account for the use of Fund resources". That is precisely my concern : that, by approving the stand-by today, as it is, the IMF signals to the world its unwillingness to consider an issue of utmost importance for the international financial system.

We deeply regret for Panama that it turned out to be a test-case, a fate which could have befallen any other country featured on those lists. But, whether we like it or not, Panama is that test-case, and we have to treat its request for a program accordingly.

We, therefore, cannot support such a program.

However, in a spirit of consensus, I could abstain, but only on the condition that the summing-up and the subsequent Fund's press release include a strong message to the Panamanian authorities that they must urgently make significant progress in financial supervision and regulation, in response to the concerns expressed by the international community. These statements should send a clear signal to the authorities that tangible steps, clearly demonstrating their willingness to address their financial supervision weaknesses in a fully cooperative spirit, are needed in the very next future.

In fact, doing so would be the best way for the authorities to respond to what they perceive as undeserved criticism, to improve their image in the international markets and to ensure the long-run sustainability of their financial activities.

Mr. Abbott made the following statement:

Panama is well positioned to enjoy a period of period of sustained strong growth. Reversion of the canal area has generated attractive investment opportunities that are already being energetically exploited. The service sectors that are the backbone of the Panamanian economy—trade, transportation, telecommunications, tourism, finance...all have favorable prospects.

For this opportunity to be fully realized, macroeconomic policy will need to provide a stable financial environment. For the past couple of years, wobbly fiscal policy has unsettled market conditions. Fiscal overruns caused the extended arrangement negotiated with the previous government to go off track in October 1998. Spending squeezes limited the fiscal slippage in 1999 but new budget commitments this year have again raised concerns that public sector borrowing requirements are not sufficiently disciplined. According to the LOI, the modified budget for 2000 would result in a PSBR of 4.2 percent of GDP if fully executed. Persistent high sovereign risk spreads and warnings

of possible downgrades of Panama's credit rating have been clear signals that the government's fiscal plans needed retooling.

This proposed Stand-By Arrangement provides a framework for fiscal discipline. Under the program, the fiscal deficit for 2000, rather than expanding to 4.2 percent of GDP, will decline to 1.0 percent of GDP. This will only be a small improvement over the 1999 outturn of 1.4 percent of GDP, but it is a lot better than the track Panama was on without the additional measures promised under the program. To get the deficit down to the new targets for 2000, the government has committed to squeezing investment spending, curtailing civil service employment, and curbing other current spending. Underexecuting a budget is, of course, a time-honored technique for meeting Fund program performance requirements. This may be an acceptable device for moving forward this year but, as a matter of good governance and fiscal credibility, we would hope that the budget proposed for next year will show a closer correspondence between budget authority and fiscal objectives.

The staff update on the Trust Fund for Development is welcome news. Under the new legislation, the Fund will be managed as a true trust, generating additional current budgetary revenue to support worthwhile social spending, without depleting the principle. This is an important piece of legislation.

For 2001, the government proposes to mobilize an additional ½ percent of GDP in additional tax revenue. The base broadening measures mentioned in the staff report sound reasonable. They will, however, require legislation. A structural performance criterion for the program calls for the government to submit the necessary tax legislation to the National Assembly by September 30, 2000. Like Mr. Oyarzabal, I would find it useful to get some sense of the likelihood that the required legislation will be approved in a timely fashion.

I agree that for long-term fiscal discipline, Panama needs to begin to address the financial imbalances of its social security. Fundamental reforms will undoubtedly take time. I am pleased that the authorities plan, by October 31, to appoint and start the work of a high-level commission to seek a solution to the CSS's problems. This is a useful, but not very demanding, benchmark to have in the program.

Financial regulation features prominently in the structural performance criteria of this program. Unfortunately, these requirements break little new ground beyond existing policy. The requirements are basically to issue a final set of regulations that have been in preparation for some time and to begin examining banks. As Mr. Faini notes in his statement, banking supervision has only belatedly become part of Panama's institutional landscape. There is still a

great deal to be done, and we are disappointed this program does not provide for more energetic initiatives.

It is all to the good that the superintendencia has adopted basic regulations, has staffed up, and has set itself a target of examining 30 percent of the banking system by the end of the year and the remainder by the end next year. However, there are still basic deficiencies in Panamanian banking legislation that compromise the ability of the authorities to carry out effective modern banking supervision. "Know your customer" rules are an important requirement of contemporary banking regulation. These requirements are incorporated under Principle 15 of the Basle Core Principles for Effective Banking Supervision.

It is my understanding that Panamanian financial secrecy legislation precludes the supervisors from looking at depositor name information, except under court authorization. With this sort of handicap, it is essentially impossible for the superintendencia to evaluate whether banks do or do not have adequate know your customer policies. If bank examiners can't see who the bank's customers are, they can't tell whether a bank has adequate know your customer policies. Access to customer name information is frequently an essential requirement for transaction tracing that is a routine component of effective supervision, whether this be investigating check kiting schemes or verifying the source of a bank's capital. The inability of the Panamanian authorities to carry out such examinations for themselves or to cooperate with foreign supervisors in such basic information sharing, outside the strict confines of judicial proceedings, frustrates effective consolidated supervision. This is particularly important in Panama with its large population of branches and subsidiaries of foreign banks.

Panama has the fifth largest banking sector in Latin America. International banking is a major component of GDP. Financial vulnerability has become an increasingly important part of the Fund's work. Our work on FSAPs, FSSAs, ROSCs and Core Principles Assessments has led us into deeper and more sophisticated analysis of financial sectors in a variety of countries. It is disappointing that this work has not been exploited more fully in the design of this stand-by program, where the financial sector is so important and so internationally exposed. With basic gaps in the banking legislation, counting the number of audits completed is not an adequate standard for evaluating whether supervision is or is not effective. The international community, which has asked the Fund to play the lead role in evaluating financial sector soundness, expects a higher standard.

As we all are well aware, the Panamanian banking regime has recently been singled out for public criticism by the Financial Stability Forum, by the Financial Action Task Force and by the OECD. Three for three. Without going into the ins and outs of each of these evaluations, it is transparently

obvious that the reputation of Panamanian institutions and Panamanian financial regulation is under a cloud. The Fund has a responsibility to draw its own conclusions about the merits of these criticisms, but it cannot ignore the fact that Panama falls well short of international expectations with respect to anti-money laundering, tax havens and cross border co-operation in financial regulation. More is expected of Panama than it has yet delivered. But equally importantly, this reputation creates a financial risk to Panama that should itself be a concern to the Fund.

In his statement, Mr. Portugal notes some of the steps Panama has taken over the past decade to respond to the international community's requests for closer regulation of money laundering and for better international cooperation. These steps are not insignificant. What is telling, however, is that even though some of these policies, such as the currency transactions reporting requirements and the MLAT with the United States, have been in place for almost ten years, overseas supervisory authorities who deal with Panama on a regular basis still find effective cooperation deficient.

I have read the May speech by President Moscoso to the Egmont Society that Mr. Portugal mentions in his statement. The speech is forceful and persuasive. I think it is a missed opportunity that this program did not pick up on President Moscoso's initiative to revisit money laundering legislation. A benchmark for introduction of such legislation would have been a natural for inclusion in the program. Formation of the commission that

Mr. Portugal mentions in his statement would also have been an obvious candidate for inclusion in the program requirements. Clearly, we are looking for concrete results not just process, but with this orientation, the Panamanian authorities would have been able to demonstrate concretely that they are moving to correct the deficiencies that have led to the recent international criticism of their financial practices.

Mr. Chairman, we think this proposed program provides a framework for fiscal discipline. However, like Mr. Faini, we think the program could be strengthened in a number of areas, particularly in the area of financial regulation. In order to go along with this program, we will need an understanding that the first review will address the regulatory weakness, particularly in the areas of money laundering and international cooperation. We would also insist that the Chairman's summing up should take note of Directors' concerns about the recent criticism by the FSF, FATF, and the OECD and that these concerns also be reflected in any press notice about the program.

Mr. Mussa made the following statement:

We would like to thank the staff for its comprehensive paper and Messrs. Portugal and Macia for their candid and well-balanced Buff

statement. We will not come back to the comments made on the country's recent economic developments and prospects. However, like Mr. Faini, we wonder if the premium Panama pays on its debt may be seen as some reservation of the international financial community with regard to the country's external financial viability. Also, we wonder whether the assumptions underlying growth and debt reduction in coming years are not too ambitious.

We will focus our brief remarks on three features of the Panamanian economy:

Firstly, on fiscal slippage: here lies a persistent weakness of Panama's macro-economic record. In our view, this is first a structural problem, as the fiscal base is narrow. However, we have to admit that a poor public expenditure management, which has resulted in substantial overruns and subsequent deficits, compounds the problem. The broadening of the tax base, for instance that of the VAT, and a better taxation of net income of banks may ease fiscal imbalances in the long run. On VAT, we note that a large number of goods are exempted; this underscores the difficult balance to strike between fiscal performance and social imperatives.

Secondly, on the need to strengthen financial sector supervision: although we welcome the recent creation of the Superintendency and the improvement of banks adherence to core principles such as capital adequacy, we would like to insist on the fact that the supervision of bank activities still remains weak, and that a consolidated supervision of banks and their subsidiaries is badly needed. We consequently welcome the steps taken by the authorities to curb criminal financial operations and to audit all banks by the end of 2001. In this connection, the country will need Fund's technical assistance, as well as that of other countries. Beyond the sole banking system, a more stringent supervision of the financial sector at large is a pressing necessity.

Thirdly, on income inequality and the fight against poverty: as pointed out by Messieurs Portugal and Macia, growth is unevenly distributed, and, as a result, there is a striking mismatch between Panama's per capita income level and the extent of poverty. We hope that the new President's agenda with regard to poverty reduction will be forcefully implemented, especially in indigenous and rural areas where the standards of living are particularly low. We also expect to see how the fiscal program will accommodate the country's ambitious social agenda. In this regard, reducing the high unemployment rate can significantly contribute to poverty alleviation. Similarly, we see the decision to earmark the TFD's income for priority social sectors as an encouraging step.

Finally, in line with the staff's recommendation, we support the proposed request for a SBA and encourage the Panamanian authorities to persevere in their adjustment efforts.

Mr. Collins made the following statement:

I broadly agree with the reform priorities which have been identified by the staff. In particular, I support the measures to broaden the base of sales and income taxation, and welcome the planned increased share of spending going to health care and primary education. I agree with the staff that the trust fund for development should be used to repurchase external debt. This chair has argued, not only in Panama, but also in many other countries, especially those facing relatively high debt servicing costs, that debt reduction is ultimately a more efficient means of financing social expenditure than the establishment of anti-poverty investment funds. I would also encourage the authorities to press ahead with the review of the social security system. I hope it will not be too long before we see concrete proposals on how Panama plans to deal with the challenges presented by the aging population.

Turning now to the difficult and more controversial issues of the program's treatment of financial sector issues. During the Article IV discussion of Panama, this chair, along with the French chair, called for continued vigilance in reform efforts to ensure that Panama does not become a potential haven for illegal or otherwise unsound financial activities. We would have preferred to see some discussion of these issues, in particular Panama's role as an offshore financial center and the new anti-money laundering legislation in the program documentation. These are important issues which we believe can have an impact on domestic and international macroeconomic stability, and which can also affect public confidence in economic and financial management.

I welcome the reassurances contained in Mr. Portugal's buff about the authorities' commitment to raising standards in these areas, as also reported in today's Financial Times. I agree that Panama has made some progress in improving the quality of financial supervision and regulation, especially since the establishment of the superintendency of banks in 1998. There are clearly issues regarding the Fund's role which the Board has yet to resolve. My own view is that, to the extent that they affect macroeconomic stability, they should be included in Fund surveillance and conditionality. They have been a feature of other country discussions, and Mr. Abbott gave the specific example of the Basel core principles requirement on knowing your customer as a very specific legitimate area of Fund interest.

There is a need to have a more general discussion of the priorities which this institution should attach to these issues. We will shortly discuss the staff paper on offshore financial centers and the role that the Fund should play

in assessing standards in this area. That discussion will inevitably touch on money laundering, because the two issues are linked. My conclusion is that we should not pre-empt that discussion today. We will support this program for Panama, but I echo those who have asked for the summing up to contain clear messages for the Panamanian authorities that, going forward, these issues are important to be addressed and are relevant for Fund support. I hope the summing up will be in such a form that Mr. Bauche feels they will at least be able to abstain.

Mr. Portugal clarified that a law existed that applied the know your customer policy, and he could provide detailed information later.

Mr. Schollmeier made the following statement:

We can broadly endorse staff's analysis and recommendations and support Panama's request for a Stand-By Arrangement. Recent economic developments are broadly encouraging, especially the reversion of the Canal Area offers opportunities for stronger growth.

I will highlight only some important issues:

As Mr. Faini has pointed out in his preliminary statement, Panama has received 13 arrangements between 1973 and 1997. This raises questions about repeated or prolonged use of Fund resources as well as program implementation. Some of these arrangements have gone off track, including the previous EFF. Against this background we welcome the precautionary character of the new arrangement; this seems appropriate since it is projected that the current account deficit will be covered by capital inflows.

We strongly recommend to continue fiscal consolidation and take decisive steps toward a broad-based tax system. It is of utmost importance to exercise firm control on budgetary expenditures to adhere to the program-ceilings. We are concerned about the recent modifications to the draft legislation, which imposes a ceiling of 20 percent on the Trust Fund for debt repurchases. Regrettably, this restriction could undermine the intention to reduce interest payments on public debt and the program could not assume any savings from this source.

Finally, we share the concerns on financial sector regulation and supervision and money laundering expressed by Mr. Abbott, Mr. Faini, and Mr. Bauche. It is our understanding that improvements in banking legislation and supervision are an on-going process in Panama. However, we would have preferred a deeper analysis of such important issues in the document. We encourage staff to focus on banking sector issues in the upcoming first review, i.e. to analyze the effectiveness of bank regulation and to assess the risk of financial instability. Another, even better – however time consuming - option,

could be to assess the financial sector in the framework of an FSAP. Like Mr. Bauche and Mr. Abbott, we too, are in favor of a comment on these issues in today's press release by the chairman.

Mr. Rustomjee made the following statement:

I welcome the staff paper and Mr. Portugal and Mr. Macia's helpful and detailed buff.

At the outset let me say that we fully support the new precautionary Stand-By Arrangement with Panama. Panama has enjoyed steady growth for at least ten years. Inflation has remained subdued despite increased international oil prices. Unemployment has been reducing although it remains high and considerable progress has been made in structural reform, including inter alia substantial privatizations, regulatory reforms and the promotion of competition in domestic markets. Regarding recent fiscal performance, it is encouraging to note that the excessive expenditure overruns in 1998 have been corrected by the new administration and efforts to step up expenditure control in the fourth quarter of 1999 have enabled the new administration to contain the PSBR to 1.4 percent of GDP for 1999 as a whole, compared with the programmed deficit of 1.0 percent of PSBR. We welcome staff's indication that first quarter 2000 provisional estimates for the PSBR indicate that it is likely to be in surplus by just over \$7 million. This is a clear sign that earlier fiscal reforms are bearing fruit and should be interpreted by the authorities as a signal to press ahead much more strongly with their fiscal reform efforts.

Nevertheless, the authorities face considerable challenges in the years ahead. As the staff report highlights, even though the country's per capita income level is high, nearly a fifth of the population continues to live in extreme poverty and nearly two fifths live below the poverty line. The tax base remains unnecessarily narrow and the authorities and staff have identified important public sector and financial reforms which will require to be addressed in the short and medium term. Turning to the content of the new arrangement itself, we consider the challenges facing the authorities to lie in five key areas.

Firstly, directly addressing poverty. Here, it will be important for the authorities to substantially increase the share of well-focused social expenditure in the budget and we are pleased to note that the authorities recognize this particular imperative. Relevant to this issue is the very recently promulgated legislation on the Trust Fund for Development. Certainty about the manner of distribution of privatisation proceeds will help private sector confidence and can also be a signaling device as to the priorities assigned by an administration to debt reduction and to other priority public policy purposes. The update provided by staff is welcome. The distribution proposed

appears to be reasonable and in view of Panama's pressing social needs, appropriate. Mr. Portugal and Mr. Marcia's statement provide a convincing argument to indicate the depth of poverty in the country and it is clear that the resources allocated from the TFD will be put to immediate, appropriate and urgently needed use in addressing poverty in Panama. While on this issue, it is pleasing to note that the authorities continue to maintain sound and extensive relationship with the World Bank and development of the "Poverty Map" will prove an important guiding instrument in combating poverty.

Secondly, financial sector reforms. Since its establishment two years ago, Panama's Superintendence of Banks has clearly made significant efforts to strengthen financial sector regulations and supervision. Ambitious objectives have been set and the track record to date, including progress in implementing the Basle Core Principles for Effective Banking Supervision, new regulations for insurance companies and for the stock market and stronger enforcement of capital adequacy and liquidity requirements, suggests that the Superintendence has credibility and the capacity to act. We therefore look forward to the Superintendence achieving its ambitious objective of auditing one-third of the banks by end-2000 and the remainder by the end of the following year. Yet it will be particularly important for the Superintendence to achieve the structural performance criterion established in the new arrangement. Both Mr. Portugal's and Mr. Marcia's statement as well as the staff report allude to the need for increased technical assistance to the Superintendence and we wish the authorities success in obtaining this assistance. Still on the financial sector, we note that there has been a rapid expansion of private sector credit in the last two years, with rapid growth in consumer lending fuelling aggregate demand. While consumer loans have a considerable degree of protection, we would be interested in understanding better how the significant growth in credit extension has impacted on the quality of bank's loan portfolios

Thirdly, fiscal reforms. Panama's tax base remains narrow. Reform of tax administration, as well as social security reform also remain important challenges for the Panamanian authorities and we urge the authorities to strengthen their reform efforts in these areas. We also agree with staff that the VAT base particularly is rather narrow and that there remains considerable scope for broadening the base, without necessarily increasing the rate itself. We would urge the authorities to identify previously-exempted services which can be included in the VAT base, as expanding the overall tax base will be essential if the fiscal deficit is to be eliminated, as envisaged, by 2001.

Fourthly, public sector reforms. On the proposed public sector reforms contained in the arrangement, we consider particularly important the extension of coverage of the SIAFPA project to the expenditures financed by development banks and those held over from earlier budgets; and extending

SIAFPA throughout the central government on a real-time basis by December 2001.

Fifthly a range of institutional and other structural reform measures. Here, we encourage the authorities to resolve the difficulty in the BDA and BHN and note that these comprise important elements of the new SBA. We also share staff's proposal that the short-term reversal in trade liberalization measures be corrected in the early part of the new SBA, rather than being addressed over the full course of the program.

Regarding technical assistance, while Panama is a pilot-GDDS country, we would strongly urge that Fund technical assistance be provided as proposed in the staff report, particularly in the area of national accounts and balance of payments statistics.

We had two questions for staff: Firstly on the ZLC, it seems clear that considerable reliance is being placed on an upturn in re-exports from the ZLC. Since 1997, declining re-exports from ZLC have contributed to an increase in the current account deficit from 6.9% of GDP in that year, to an average of 13.6 percent during 1998-99. It would be helpful to understand whether the destination of these re-exports is concentrated in a particular market or is diversified, to appreciate the extent to which the ZLC is vulnerable to a downturn in any particular region. Secondly, Staff indicate in Box 2 that taxable persons with a monthly average turnover between US\$1,500 and US\$5,000 pay the VAT (ITBM) quarterly, whereas those with a monthly average turnover exceeding US\$5,000 pay on a monthly basis. I wondered whether the dual payment period creates any undue administrative difficulties for the authorities; alternately, it could be that the system works well and is administratively efficient for both the authorities and for taxable persons as well and for the benefit of other countries it would be interesting to understand if this were the case.

Finally, on the issue of money laundering, like Mr. Bauche we find it very surprising indeed that the issue has not been better addressed in the staff report. But I wonder whether it would be a good precedent to come to a decision based on the reports of other institutions alone particularly where we do not as yet have a Fund policy on OFCs. This itself would establish a precedent which I think would be difficult to sustain; and even though I believe that the issue is a significant one, where more active international cooperation efforts are necessary all round, where more detail ought to have been provided in the staff report; I believe that we need to be cautious in how we proceed. Mr. Abbott has suggested that the Press statement takes note of the concerns he raises, which I believe ought to have been reflected in more detail. In view of Mr. Portugal's comments in his buff, the substantial progress which the supervisory authority has made in just two years and the very recent information provided by Mr. Portugal a few moments ago, we

would not support alluding to this issue in any external publication by the Fund. There is thus far no Fund policy on this and until such a policy has been established, it would be unfair to any single member to raise this issue publicly.

With these remarks, we wish the Panamanian authorities every success with the new arrangement.

Mr. Shaalan supported Mr. Rustomjee on the issue of the Fund using assessments made by other institutions for its own policy formulation. He said that the assessment by the FSF of offshore centers had been described as being impressionistic and as having followed questionable procedures. As that document had not been discussed with the Fund or with the members concerned, he was reluctant to use it as input to the Fund's work.

Mr. Faini said that while Mr. Shaalan's point was important, it went beyond the core of the discussion, which was that the program was relatively weak in the financial sector; a crucial area for the Fund. While there was no need to accept the assessment of other institutions, the Fund needed to be extremely careful in assessing the quality of financial supervision and of financial regulation in the Fund program.

Mr. Shaalan clarified that the basis for the discussion should not be a questionable report by the FSF.

Mr. Bauche noted that those assessments were the only references available, as there was no Fund assessment. Therefore, he had to rely on external sources.

Mr. Bernes made the following statement:

I am in broad agreement with the staff assessment, and I can support the program. The staff rightly point out that it provides a needed fiscal framework, but the emphasis has to be placed on execution.

I will focus on the financial sector, and am somewhat critical of staff for only having devoted one paragraph to that sector. I am critical because given the importance of the financial sector to the Panamanian economy, and given the concerns that were raised in the Article IV discussion in this Board the last time, I would have expected the staff to devote more attention to this sector. But, we also have to recognize that the role of the Fund in this area is rapidly evolving, and includes some areas where the Board has not pronounced on its policy.

As others have said, the existence of lists elsewhere should not direct Fund staff, and I have concerns that the process for some of these lists was flawed. There was a lack of due process, and they should not direct the work of this institution. But nonetheless, outside information can help inform the discussion and the analysis of staff. However, we need our own staff's

analysis of the situation, which can then inform the Board discussion, and we could come to our own conclusions. That is why this chair welcomes the forthcoming discussion, on the staff paper, which we believe provides a good basis for a discussion and process that will allow issues in the financial sector to be addressed.

I would have thought that the Panamanian authorities would have welcomed a stronger analysis of the financial sector as well, because it is an important part of their economy. Also, I would have thought that the reaction would have been to address the issues.

It would be appropriate to refer to the financial sector in a public release. While we can welcome Mr. Portugal's statement and the report in the Financial Times of the steps the authorities are taking, we should note the interest the Board has in a strengthened regime within the financial sector and that we have requested staff to report further within this area.

Mr. Melhem made the following statement:

I thank staff for a well-written report and endorse Panama's request for a stand-by arrangement. I am in broad agreement with the staff appraisal and will make only brief comments.

First, the projected increase in growth rates appears optimistic. Both investment and public consumption are projected to decline. Moreover, private consumption could also suffer as households reduce their spending, given the sharp increase in their indebtedness and the increase in U.S. interest rates. In addition, the expected slowing down of the U.S. economy could reduce external demand.

Second, the sharp decline in the unemployment rate last year is encouraging. However, the reasons for this decline are not clear.

Finally, I welcome the comments made in the buff statement by Messrs. Portugal and Macia on strengthening financial regulation and supervision.

Mr. Josz made the following statement:

I associate myself to the statement by Mr. Faini about the broad assessment of the program. I share the disappointment expressed by many that the program does not address forcefully enough weaknesses in financial supervision. I support that this concern be reflected in the summing up and in the press release. It is important that staff brief the Board about progress in these areas at the occasion of the reviews of the arrangements. I also believe that undertaking a financial sector assessment program with the assistance of

the Fund and the Bank, would go a long way to alleviate the concerns of the international community about the quality of financial supervision in Panama. I would like to ask the staff whether this is being considered by the authorities.

Ms. Jul made the following statement:

I support Panama's request for a stand-by arrangement, and believe that the program provides a framework for fiscal discipline. We also welcome the decisions made regarding the use of the trust fund for debt repayment and on social spending, considering the poverty levels faced by the country. We join other Directors in expressing the need to broaden the tax base, and particularly to also strengthen further the financial sector regulation. In this respect, I also join other Directors in asking to be briefed on this issue at the time of the first review.

Regarding the definition of the appropriate Fund policy to be followed regarding the issue of money laundering, I associate myself with Mr. Collins' views. On publication, I associate myself with Mr. Bernes' views that it should reflect in a positive way on the measures that have been taken rather than highlighting the deficiencies based on the lists of other institutions.

Mr. Mirakhor made the following statement:

Let me thank the staff for their paper. I heard a number of Directors criticizing the staff for not including a discussion on money laundering, and other weaknesses in financial supervision. However, if they would have included those issues they would have also been criticized, as they should have waited for a general policy from the Board. I look forward to the forthcoming discussion on that issue.

I fully support Panama's request for a stand-by arrangement, and I also thank Mr. Portugal for his statement. On the specific issue of money laundering, this chair, between 1985 and 1988, repeatedly called the Board's attention to money laundering, and asked for a Fund convention on money laundering. Of course, it went unheeded. Now, we should wait until we discuss the relevant paper and then lay down a general policy. We should not single out a country unfairly. While, this Board does not want to be unfair to any individual member, we can express concern. But, I oppose any reference to money laundering in the final statement or in the press release. However, some language regarding the need for strengthening the financial sector, provided it is coupled with Ms. Jul's and Mr. Bernes idea taking account of the country's efforts, may be appropriate.

With these remarks I wish the Panamanian authorities all the best.

Mr. Oyarzabal made the following statement:

I associate myself with Mr. Mirakhor's statement, particularly with respect to the issue of the summing up, and any public statement that might be made with respect to the request for a stand-by arrangement by Panama. I also request some clarification from staff about the elements involved on this issue. When can results be expected from the superintendency which has been installed for two and a half years now? We have had many cases where legislation has been approved but cannot be implemented. We must be very clear that the issue is the correct implementation of the proper policies, and not only the approval by the legislature.

Mr. Shaalan made the following statement:

I can fully support the staff analysis and the recommendations as well as Panama's request for a stand-by arrangement. We are of the firm view that there is a need for strengthening the regulatory and supervisory environment for Panama's banking system. Mr. Portugal and the authorities shared that recognition. That is based on staff's references to weaknesses in the last report discussed on Panama, as well as on the size of the financial sector in the country. Also, the increasing complexity of financial transactions require any country to strengthen its supervisory and regulatory environment.

I do not favor including a statement in the press release, but can go along as a compromise with Mr. Bernes' suggestions supported by Ms. Jul and Mr. Mirakhor's amendment.

Mr. Hililan made the following statement:

We broadly agree with the staff appraisal. The issue of financial supervision and regulation is best expressed by Messrs. Bernes, Mirakhor and Shaalan. While we share the view of others that this area needs to be strengthened, we should address this issue when the Board discusses the upcoming paper on offshore financial centers. We feel, like Mr. Rustomjee, that if the Fund goes forward now, it could set a precedent for holding back on the program with Panama until a policy on money laundering exists.

Mr. Kelkar made the following statement:

Mr. Chairman, I want to first thank staff for an excellent report and analysis with which we agree. I also want to thank Mr. Portugal for his important statement. This chair supports the Panamanian authorities' request for a stand-by arrangement. I also agree with Mr. Faini's observation about the important trade policy issues in the Panamanian program, that may require some attention. Regarding the summing up, I agree with Mr. Bernes, Ms. Jul, and Mr. Mirakhor.

Mrs. Hetrakul made the following statement:

We thank the staff for a comprehensive paper on Panama's request for a Stand-By Arrangement. While the fiscal performance went off track during the former government, the new Administration has made excellent efforts to reduce the fiscal deficit, sustain economic growth, keep the inflation rate at low levels and continue with the structural reform initiatives. The declared objectives of the proposed new arrangement are a clear indication of the commitments from the authorities to tackle the underlying challenges facing the economy. We agree with the staff appraisal and fully endorse the proposed decision to approve the requested Stand-By Arrangement; however, the following comments are offered for emphasis.

The continued efforts of the new Administration to put fiscal management back on track are excellent endeavors. Deepening of fiscal consolidation by cutting back both non-social current and capital expenditures to the levels prior to the pre-election period and gradually reducing public sector borrowing to zero would certainly serve the purpose. However, the efforts to increase expenditures for primary education and health care should not be affected, as they are needed to fight against poverty. On the revenue side, the proposed increase in banks' income tax and cutting of tax exemption and preferences would further strengthen the fiscal position.

On structural reforms, we welcome the various steps taken by the authorities in this area. The appointment of a commission on social security to tailor the ILO recommendations for local needs prior to implementation is appropriate and the improvement in social security collection is a good sign. Improved financial legislation, regulation and supervision through the Superintendency of Banks are a forthright approach in order to press ahead with the implementation of the Basle Core Principles for Effective Banking Supervision. Furthermore, the recent commitments of the highest authorities to strengthen legislation and regulations to keep pace with the expansion of money laundering in the world is an outstanding and commendable initiative. On privatization, we welcome the continued efforts in the divestiture and rationalization of the commercial enterprises in government to improve private sector involvement and domestic production.

On the balance of payment issue, we note that the medium term projection is being conditional on the successes expected of the fiscal consolidation and structural reform efforts. Export flow is likely to be strengthened from the recovery of the ZLC's existing markets, as well as the improved port facilities, and sizable investments in storage and transport facilities.

Finally, we note that Panama is included in the list of tax havens recently published by the OECD, with warning sanctions in a year from now

if the situation does not improve. However, we trust that the authorities' strong commitment to tackle the problem, as expressed in Mr. Portugal's Buff, will be effectively put to action. That aside, we strongly oppose any effort to link the OECD's agenda with that of the Fund. The issue of money laundering has never been a policy element in the discussion of Panama's use of Fund resources.

So given the strong program and commitments from the new Administration, we fully support Panama's request for the Stand-By Arrangement, and wish the authorities success in their future endeavors.

The staff representative from the Western Hemisphere Department made the following statement:

I will give some background on the authorities' anti-money laundering program before discussing the broader issue of financial regulation. In the last 13 years, the government of Panama has enacted about 19 laws or amendments to existing laws that were intended to impede the use of Panamanian registered banks for money laundering. Banks found to be in breach of these laws are subject to heavy penalties. These laws have been supplemented by cabinet decrees which do not require legislative approval, and by agreements between the national banking commission, - the predecessor of the present superintendency-, and the commercial banks. In addition to the treaty with the United States, Panama has anti-drug and anti-money laundering agreements as well as treaties of mutual legal assistance with the United Kingdom, Cuba, Peru, Uruguay, Costa Rica, El Salvador, Honduras and Nicaragua.

The Financial Action Task Force makes four criticisms of Panama's anti-money laundering regime. First, Panama has not yet criminalized money laundering for crimes other than drug trafficking. The staff's understanding, however, is that the emphasis on laundering for purposes related to drug trafficking stemmed from the fact that this was the major source of money laundering activity in the region.

A commission was appointed some time ago into broadening the laws and widening their ambit to cover any illicit activity ending in money laundering. The superintendent has already announced publicly, and confirmed to us by phone, that the commission is now on a fast track. She was quoted in the Financial Times as saying that laws could be drawn up by July 31, which would criminalize money laundering in general and not just money from drug trafficking.

The second point made by the Financial Action Task Force was that Panama had "an unusual and inefficient mechanism for transmitting suspicious transaction reports to competent authorities". Our understanding,

based on a discussions with the superintendency is that this is not accurate. Compliance officers in each bank must forward reports of suspicious transactions to the superintendency. The superintendency's financial analysis unit then investigates that activity. If the suspicions are confirmed, the case can be passed on to a commission in the office of the Attorney General. If it is then confirmed that money laundering is taking place, the financial intelligence unit in the Attorney General's Office will take over the case.

The third finding was that Panama's financial intelligence unit is not able to exchange information with other FIU's. However, while it can respond to a criminal investigation in other countries, it is not proactive and therefore the transmission of information goes in one direction only.

Finally, the superintendency has agreed with the Financial Action Task Force's findings that it is possible for a trust to be held by nominal shareholders in such a way that the true beneficial owners of these trusts are not identified.

On the broader question of financial supervision and regulation, the concern of the mission and the concern of the Article IV consultation was the impact of the financial system on financial stability. We felt that it was appropriate to place emphasis, therefore, on basic supervisory and regulatory reform as opposed to the specialized aspect of regulations that involved anti-money laundering. The Article IV consultation report discusses the issue in-depth.

The legal basis for supervision in Panama is that the superintendency has the right to audit any bank to which it has issued a license. Any bank operating legally in Panama has to have a license. This includes the so-called general license banks; i.e. banks licensed to do business in Panama as well as off-shore, and so-called international license banks which include the off-shore branches of nonresident banks. Panama, unlike most other OFCs, requires a genuine presence of the off-shore banks. That presence should include a responsible official of the bank and adequate financial records. In fact, the deposits of the general licensed banks exceed those of the offshore or international licensed banks in Panama. Domestic business has grown more in recent years than the international business, and foreign assets of both general licensed banks and international licensed banks amounted to \$19 billion about one year ago.

The law gives the superintendency the right to carry out on-site inspections and audits of Panamanian banks with off-shore branches and also provides the right to carry out audits to the supervisory authorities of a country whose banks have branches in Panama. That requires a bilateral Memorandum of Understanding. In addition, the law provides substantial penalties for banks that do not comply with informational requirements to the

superintendency. It is our understanding that the superintendency has access to any account, numbered or named, and that know your customer rules apply universally.

The reason for the superintendency not setting a figure of 50 or 60 audits in 2000 was that it was serious enough in its endeavors to know that it could not guarantee the quality of such an amount of audits in that timeframe. The superintendency is well aware of the importance of quality, but it has to be accepted that while it now has the full panoply of regulations to administer, it is still in the process of developing the staff. This is reflected in the quantitative goals for bank audits that we agreed with the superintendency. The superintendency, has committed itself to reviewing the audit program by the end of the year, and is also committed to taking remedial action, should problems with the program exist. We should not penalize a country that is making a reasonable effort. If quality is judged by the number of bank failures or instances of financial instability, then Panama has done well. It would not be placed on the black list of financially unstable countries or on the list of countries where banks underwent large governmental bailouts.

Recovery of exports to the Colon Free Zone is slow, and exports will not surpass the 1998 level until 2003. ZLC's number one customer is the United States, with Colombia second and Brazil in third place. Exports have suffered from difficulties experienced by neighboring economies, but we expect that these difficulties will be alleviated. It is reasonable to suppose a moderately rapid recovery of exports.

On the implications of monthly filing for larger taxpayers and quarterly filing for smaller taxpayers, that is an issue we will bear in mind the next time we are in Panama. It is not an unreasonable requirement to allow very small taxpayers to file as frequently, although opinions differ on this subject.

On the subject of the repeated user issue, I would suggest that Executive Directors visit the Treasurer's Department Web site where a list of the programs that Panama has had, and the book transactions of the Fund, are available. For example, the stand-by arrangement that was agreed in 1977 had total access of 11 million SDR, of which none was drawn. In fact, the amount drawn is zero for nearly every arrangement in the late seventies and early eighties. Also, the rate of the programs has declined in the last 15 years, while four programs, including the EFF, have been canceled in that time.

I want to be on record, qualifying some of Mr. Faini's remarks about the program condoning a major reversal in trade liberalization. In the fall of 1999, my colleagues and I tried to convince the Minister of Agriculture that protectionism was not a very good idea, and we were appreciative of

arguments in favor of favoritism. We do not condone that, and the government should admit it made a mistake by reversing its actions.

On the high incremental capital output ratio in Panama, problems exist with the measurement of GDP and growth and the measured rate of investment. Investment may be overstated and the growth output could be underestimated. We also differ as regards the 10-year period ending in 1990, we have a geometric average rate of growth of GDP of 5 percent.

On the indebtedness of public financial institutions, a small difference exists between total indebtedness of the nonfinancial sector and the public financial sector.

Mr. Bauche noted that he would have appreciated it if staffs' comments had been included in the initial staff report or in the supplementary staff report. He had also seen the FATF report.

The staff representative from the Western Hemisphere Department explained that his information regarding the transmission of reports was based on conversations and correspondence with the superintendency. He was not qualified to lead a mission to deal with the issues of financial regulation, but he had reiterated the views of the Financial Action Task Force, and those of the superintendency. While some impediment to the transmission of information existed, that did not concern the flow, but rather the initial action. Panama responded to the requests of other agencies only, but did not take action on its own. That was a shortcoming. However, as the superintendent had announced, the new laws would speed up the procedures for investigating suspicious transactions, and facilitate the cooperation of the financial intelligence unit with other units worldwide.

On trade liberalization, Mr. Faini noted that a policy reversal had occurred. If that was a mistake, the Fund should not have accepted that that mistake only be reversed over the next four to five years.

On the financial sector, he concluded that if the improvements on financial supervision and regulation proved to be correct, then the Panamanian authorities should be the first to have a full assessment of the Basel Core Principles. That would show that the accusations put forward were not warranted. His expectation was that Panama would benefit from such an assessment, and he hoped that the authorities would take the initiative in that respect.

The staff representative from the Western Hemisphere Department agreed that that would be a good idea.

The staff representative of Policy Development and Review Department made the following statement:

Mr. Faini, in his statement, pointed out correctly that the SBA would be the 19th Fund arrangement that Panama has had since 1965. But, it is also the case that 12 of those 19 arrangements were precautionary. There was no intention by the authorities to draw on them, and the current arrangement is also going to be precautionary. The outstanding level of Fund resources are 42 percent of quota at this time, which puts Panama in the lower norm for Fund members. That level would decline to 25 percent of quota at the end of the arrangement, if the authorities were not going to draw, as they have announced. This arrangement is viewed by the authorities as a tool to pursue policies which are in the fundamental interests of Panama, and as a signal of support from the international community for that effort.

There is a difference between prolonged use of Fund resources and heavy use of Fund resources. Repeated use of precautionary arrangements, are a way for the Board to give endorsements to a country's policy. While Panama has had a number of arrangements, it is not a case of prolonged use.

On staff condoning the trade actions that the authorities have taken, we would have liked to have seen the authorities reverse this policy more quickly. Could staff have argued the case more in the discussions with the authorities? That is a fair question. But, according to staff in the Trade Policy Division, Panama's trade restrictiveness rating was one. That is the most liberal rating in the system. Therefore, it was decided that the staff did not have a good case to make that these restrictions were a significant impediment to Panama, particularly since a number of Fund members ratings are much higher, including in the EU.

On the soundness of the financial system, staff agrees with Directors' concerns. Staff held long discussions with the authorities on how the banking system is contributing to the current account deficit and how it is financing itself abroad. That needs to be closely watched. However, Panama's banking system has better access to credit than the government. While the government borrows at about 450 basis points above U.S. Treasuries, the banking system borrows at about 150 basis points above U.S. banks. Therefore, the banking system is viewed to be a better creditor than the government. That is one of the reasons why the staff emphasized repeatedly in the discussions with the Panamanian authorities that they need to address their high debt level, a point that credit rating agencies have also repeatedly made to them. Additionally, the issue of the use of Trust Fund resources is connected closely to the credit rating.

On the broad policy question, staff takes the view, as also expressed by Mr. Mirakhor, that we need to have a general policy first on these issues

before we begin applying them, so that we can apply the policy in an even-handed fashion. At the same time, that allows the membership to know what the Fund's policies are regarding access to its resources before the Board considers that, and before negotiations begin. The proper order for the Fund is to first arrive at a policy in these areas, and have that disseminated, and then to begin applying that policy. In this case that policy would be applied at the time of review of this program.

In this connection, Mr. Crocket, who is the chair of the Financial Stability Forum, has recently written a letter to the members of the forum on the controversy of publishing the list. In that letter, he states that in publishing the list, the idea was not to take any immediate action against those countries, but to indicate the desirability of undertaking an early assessment. The survey is not intended to lead to any consequences, except to further a more thorough assessment. At this time the Fund should not go further than that, until the Board has agreed to a policy.

The Acting Chairman said that he had discussed the issue with the Legal Department and the Policy Development and Review Department. The Fund faced a complex situation because it did not yet have a policy regarding this matter. However, the paper on off-shore financial centers would be discussed in the coming weeks. The Fund needed to be careful about addressing these issues, and about establishing an own preferred methodology, but at the same time to be aware of the needs of the international financial community.

He proposed to address the general concerns expressed in the summing up. As regarded the language in the press release he suggested that to be strong but positive.

Mr. Abbott said that the issue had to be handled with care. He understood from staff's comments that disagreement existed between the self-assessment of the Panamanian authorities on their situation, and the considered assessment of three different international bodies. There was a problem with Panama's reputation, and the Fund could not remain in the position of approving a program with Panama without taking note of that in the summing up in a public fashion. However, he could not support a positive, strong statement, as that would be counterproductive. That would put the Fund in the position of saying that Panama was doing fine. Other institutions who had taken a systematic look at the country, would believe that the Fund did not know what it was talking about.

Mr. Bauche preferred a positively strong PIN rather than a strongly positive PIN.

Mr. Wei supported Mr. Mirakhor's comments on the issue of publication and the summing up. He also supported Mr. Bernes', Ms. Jul's and Mr. Mirakhor's compromise proposal, as well as the authorities' request for a stand-by arrangement.

Mr. Portugal made the following concluding remarks:

I would like to thank staff, specifically Mr. Mackenzie and his team, for the excellent technical advice and assistance they have given to Panama and the hard work they have put into the negotiations of the stand-by arrangement. I would also like to thank Executive Directors for their valuable comments and suggestions. I will transmit them to my Panamanian authorities.

As mentioned in my statement, this is a well-designed program with a strong fiscal component, which is to eliminate the fiscal deficit and to bring about a substantial reduction in the debt-to-GDP ratio in one year. If implemented, it will be a strong program. The program is also strong in terms of the continuation of a comprehensive agenda of structural reform which the authorities had started earlier and will continue to pursue. These are the two areas where the authorities had instruments of economic policies because they are a dollarized economy. We do not have an independent monetary or exchange rate policy.

I therefore, regret that due to the issue of money laundering this program has become somewhat controversial to Directors. It is an issue to which our chair attaches the greatest importance, but it is also an issue which is new to the Fund, and where we still do not have a policy. It is not good policy to make ad hoc policy in each case because we might be unfair. Also, we are not well equipped to discuss that issue today because we lack adequate information to take a considered position.

Panama has publicly stated that it will make an additional effort on that issue. I received a document yesterday from the superintendency of banks of Panama where they apply the 21 criteria used by the Financial Action Task Force, to classify noncooperating countries, and also respond to the five specific questions posed to them by the task force. I am not an expert on this, but it seems that while they may have problems in these areas, the problem of misinformation also exists. We are therefore not in the best position to discuss that issue today.

On the question of the summing up and the PIN, it has always been our position that what has been discussed at the Board should be reflected in the summing up, as that is the purpose of the summing up. We therefore have no objections to incorporate what was discussed today, provided that all views expressed are reflected. However, we have taken the decision of dividing the information up into the summing up for internal purpose and the press release for external purpose. That was done because it would be counterproductive to approve the precautionary program with the main aim of confidence building and at the same time express doubts. This would be a self-defeating exercise.

My understanding is that in the chairman's public statement, we will have a summary of the main points made in the meeting, which are supposed

to be generally positive because the objective is to create confidence and should not focus on Directors' reservations, if the program, as a whole, is approved. I hope that Panama will not be the first country to decline a public press release, if a common agreement on the release cannot be found.

I ask that we are careful in the drafting of the language of the press statement because Panama is of the opinion that they do not have more problems than other countries on the list. The perception could be damaging for them, as they are a dollarized economy, and do not have a lender of last resort. Panama depends more than other countries on maintaining good relations with other international financial centers, and could therefore be more damaged by a negative view. If we agree on compromise language as suggested by Mr. Bernes, Ms. Jul, and Mr. Mirakhor, then I would support the external press release. However, I ask for the time which is allowed for Directors to consult with the authorities, because for them this is a serious issue.

The Acting Chairman explained that the chair had the obligation to reflect the main issues of the discussion in the summing up. That also had to be reflected in the press release, even though that could be in a briefer or slightly different manner.

The Acting Chairman made the following summing up:

Executive Directors supported Panama's request for a Stand-By Arrangement, and agreed with the thrust of the staff appraisal. They welcomed the authorities' resolve to achieve their social objectives within a sound macroeconomic policy framework centered around the further consolidation of the public finances.

Directors supported the government's objective of eliminating the borrowing requirement of the nonfinancial public sector (PSBR) in 2001 with a view to reducing the net debt-to-GDP ratio. They also noted that the programmed reduction in the deficit was being achieved without compromising spending on well-targeted social expenditure programs.

To ensure compliance with the program targets, Directors stressed the need to exercise expenditure restraint beyond the allocations of the modified budget and, to this end, supported plans to extend the coverage of the automated financial management system (SIAFPA) throughout the central government. To support the expenditure restraint, Directors encouraged the authorities to seek early legislative approval of the measures to broaden the base of the value-added tax and increase the effective rate of taxation on bank income. They also welcomed efforts to strengthen tax administration.

To help contain demand pressures, Directors urged the authorities to ensure that any additional investment expenditures financed with resources

from the Trust Fund for Development (TFD) be fully offset by expenditure reductions elsewhere in the budget. They noted that the use of the TFD to repurchase external debt obligations was an attractive option.

Directors felt that it was important that the authorities enhance the efficiency of the enterprises that remained in the public sector, and in particular they recommended the rationalization of the operations of the water company. Directors concurred with the plans to rationalize the operations of the agricultural bank (the BDA) after a comprehensive external audit, and to present legislation to close the mortgage bank (the BHN). They stressed the need to better target new BDA loans to small farmers and to increase the transparency of any BDA loan subsidies by including them in the government's budget.

Directors noted that the financial position of the social security system (CSS) could be expected to worsen over time, given demographic trends. Consequently, they welcomed the authorities' commitment to establish a commission to review the system's functioning and to propose appropriate measures to redress its financial imbalances. At the same time, however, they stressed the need for concrete action in response to the commission's findings, including the preparation and submission to the legislature of legislation to strengthen the system's finances.

Directors welcomed the progress made by the Superintendency of Banks in establishing an appropriate regulatory framework for the financial sector. Looking forward, Directors observed that the regulatory authorities face an important challenge in addressing financial supervision weaknesses, including those related to the supervision of offshore banking activities. They urged the Superintendency to strengthen the institution's monitoring and enforcement capabilities, and particularly to improve its anti-money laundering regime. Directors indicated that the forthcoming review of the program, in addition to the fiscal issues that have been raised, should focus on progress in strengthening financial sector supervision.

Directors welcomed the government's decision to reverse the tariff increases announced in late 1999 and early 2000 on various foodstuffs, and advocated that such reversals be front-loaded as much as possible. Directors noted the authorities' intentions to upgrade Panama's statistical infrastructure. Better and more timely statistics would facilitate the task of economic policy and enhance the quality of program design. In this regard, they supported the authorities' request for technical assistance from the Fund's Statistics Department and their commitment to raise the Statistics Directorate's budget allocation in the year 2001.

The Executive Board took the following decision, with one abstention from Mr. Bauche:

1. The government of Panama has requested a stand-by arrangement in an amount equivalent to SDR 64 million for the period from June 30, 2000 to March 29, 2002.
2. The Fund approves the Stand-By arrangement as set forth in EBS/00/107, Sup. 1 (7/13/00).

Decision No. 12224-(00/65), adopted
June 30, 2000

**4. REPUBLIC OF LATVIA—2000 ARTICLE IV CONSULTATION; AND
REVIEW UNDER STAND-BY ARRANGEMENT**

The Executive Directors considered the staff report for the 2000 Article IV consultation with the Republic of Latvia (EBS/00/109, 6/15/00; and Cor. 1, 6/29/00), together with selected issues and a statistical appendix on the Republic of Latvia. They also had before them a staff paper on issues and prospects with respect to pension reform in the Baltics (SM/00/117, 6/16/00), as well as a paper on saving, investment, and external adjustment in the face of exogenous shocks with respect to the Baltics (SM/00/121, 6/16/00).

The staff representative from the European II Department submitted the following statement:

The Latvian government has completed the three prior actions required for Board consideration of the first review of the stand-by arrangement.

First, the Minister of Finance has provided a list of contingency expenditure reductions, amounting to 0.5 percent of GDP. These measures would be implemented should the external current account deficit fail to decline in line with projections or foreign direct investment fall significantly short of expectations. The identified measures include reductions in spending on specific goods and services and selected investment projects across a number of ministries and special budgets; allowing selected vacancies to go unfilled; and additional across-the-board spending reductions.

Second, the necessary steps have been taken to reverse backtracking in the area of public expenditure management. In particular, the Ministers of Finance and Economy have submitted letters to Fund staff stating that, from now on, all privatization receipts—other than for those legally earmarked for administrative costs and the reserve fund of the Latvian Privatization Agency and for transfers to local government privatization funds—will be transferred to the Treasury. This policy has also been agreed to by the full cabinet of ministers, which has also approved the Supplementary Memorandum of Economic Policies.

Third, a draft law streamlining tax benefits granted to enterprises in free ports and eliminating benefits not consistent with EU regulations, has been submitted to parliament.

Developments since the issuance of the staff report have been broadly in line with the program. Economic activity continues its recovery, with real growth for the first quarter of the year estimated at 5.3 percent. The 12-month rate of consumer inflation declined to 3.2 percent in May. Preliminary data for end-May indicate a cumulative fiscal deficit of about LVL 25 million, compared with an end-June target of LVL 54 million. In addition, net international reserves at end-May were above the program floor, and net domestic assets of the Bank of Latvia below the program ceiling, for end-June.

Extending his remarks, the staff representative informed that official balance of payments data for the first quarter of 2000 had been released earlier during the current day. The current account deficit was estimated to have narrowed to 4 percent of GDP during the first three months of the year, which compared to a deficit of 6 1/2 percent of GDP in the first quarter of 1999, and to a projection for the first quarter of 2000 of above 6 percent of GDP. Those better-than-expected results reflected growth in exports of about 12 percent and a significant improvement in the services balance, especially in transportation. Foreign direct investment had covered about 100 percent of the deficit during the first quarter of 2000.

Mr. Lehmussaari submitted the following statement:

My Latvian authorities wish to thank the staff team for their candid analysis of recent economic developments and balanced policy advice aimed at the reduction of potential risk to external sustainability. Last year was a difficult one for many countries affected by the Russian crisis. However, the Latvian government responded decisively by implementing a number of corrective measures and proved their ability to cope with external shocks in an efficient way. My authorities are delighted that constructive cooperation with Mr. Schiff and his team has developed into a number of important steps to promote economic development.

In May 2000, the Latvian Parliament gave its confidence to a new Government, which has a large parliamentary majority. In a few days a new Declaration on the government's work agenda based on the principle of continuity of policies was approved. The government is committed to speed up structural reforms and to continue fiscal consolidation.

Immediately after taking office the new government hosted the Annual Meeting of the EBRD in Riga – perhaps, the most notable financial event in the Baltics during the decade of transition. The EBRD decision to select Riga as the city for its Annual Meeting could be interpreted as an international

appreciation of Latvia's progress in the final stage of transition. On the occasion of the Annual Meeting, the Prime Minister assured the business community that his Cabinet is determined to reinforce fiscal consolidation and to bring privatization to the completion point.

The Latvian authorities have put EU membership at the center of their economic and political agenda. Recently (end-March, 2000), in the framework of the EC-Latvia Joint Assessment of Economic Policy Priorities, the government adopted a new version of the medium term economic strategy, which fully corresponds with the program supported by the SBA. In June, during the meeting in Luxembourg, the provisional closing of the five chapters of *acquis communautaire* was confirmed. EU accession provides the strongest incentives for the continued implementation of the SBA supported program.

Recent economic developments and outlook

In 1999, the growth of the Latvian economy was roughly flat, but the economic rebound started to gain momentum in the fourth quarter of 1999. Fostered by export growth, GDP increased by 5.3 percent on a year-on-year basis in the first quarter of 2000, while inflation remained low. The unemployment rate fell to 8.8 percent in mid-May 2000, significantly below its peak of a year ago.

The current account deficit slightly decreased in 1999, and the overall balance of payments remains in surplus. In 1999, FDIs were sufficiently sizeable and, together with net portfolio investment, covered about 70 percent of the current account deficit. The external debt-to-GDP ratio stood at a relatively low level of 22 percent, of which the public debt-to-GDP ratio was only 12 percent. Short-term debt vis-à-vis reserves are at a comfortable level. Latvia is able to successfully compete in international markets. This view is underlined by an adequate level of external competitiveness, as measured by dollar wages, export market shares, and unit labor costs. The authorities will continue to monitor Latvia's competitiveness.

The medium-term outlook is favorable. Economic growth in the EU and revitalization of CIS markets will help to maintain the export-led recovery in Latvia. The recent increase in domestic lending and the pace of structural reforms should promote investments and generate robust growth over the medium term. Inflation is expected to remain low. Faster growth should bring unemployment down.

The key challenge is to bring down the current account deficit, to attract more FDI, and to strengthen Latvian competitive capacity. The authorities are committed to implement the best possible "medicine" against potential external imbalances. Like the staff, they consider that fiscal

tightening, coupled with structural reforms, is the only preventive measure to a potential risk to Latvia's external sustainability.

Exchange rate and monetary policies

The fixed exchange rate policy has served Latvia well in bringing down inflation and creating a stable framework for economic growth. The authorities believe that the SDR peg has significantly enhanced the credibility of their anti-inflation policies and have no intention to alter it in the near future. They recognize the benefits of the euro peg, but a shift in the lats peg from the SDR to the euro should take place, at the earliest, at the time of Latvia's accession to the EU. Joining the euro area will require Latvia's membership in the ERM2 mechanism for two years.

Due to the fixed exchange rate regime, the monetary policy of the Bank of Latvia (BoL) incorporates all elements of the currency board arrangements (full backing of the monetary base, free convertibility of the national currency, automatic interventions). However, in its operational practice the BoL acts as a fully fledged central bank, managing the liquidity in the banking system by using its monetary policy instruments. Monetary policy instruments of the BoL are consistent with the monetary policy framework employed by the European System of Central Banks.

Starting from December 1999, the reserve requirement for credit institutions in Latvia was lowered by one percentage point (from 8 to 7 percent). Over the next 5-7 years the BoL intends to gradually lower the reserve requirement ratio to the 2 percent level set by the ECB. This move, on the one hand, is fully consistent with Latvia's integration strategy into the EU and, ultimately, the EMU. On the other hand, it will remove the burden placed on the banking system by reserve requirements which are not remunerated, thus facilitating the financial intermediation and enhancing the stability of the monetary policy pursued by the BoL. After the reserve requirement is brought in line with the ECB requirements it is not envisaged that it will be used as an active monetary policy instrument.

The BoL has always clearly demonstrated its determination to defend the currency and has by now established a high degree of credibility in the financial markets. The credibility in the central bank in Latvia is proved by the fact that there is practically no need of foreign exchange intervention in the BoL day-to-day operations, and the markets always calm down quickly after each shock. At the end of April 2000, net foreign assets of the BoL reached USD 881.2 million, which amounted to 105.8 percent of the monetary base. The amount of net foreign assets covered 3.7 months of imports.

In May 2000, BoL auctioned for the first time foreign exchange swaps with a maturity of two years to foster long-term lending in lats by commercial

banks. The auctioned amounts were moderate and the overall amount of auctioned swaps will be strictly limited. The BoL is convinced that operations should not adversely affect its conduct of monetary policy. The experience of the issuance of auctioning foreign exchange swaps will be discussed with the staff during the second review of the program.

Fiscal policy

The key component of the program is fiscal consolidation. My authorities clearly understand that, given the limitations of monetary policy, keeping the current account deficit within sustainable limits requires strong discipline on the fiscal side.

The general government fiscal deficit was in line with the program in 1999 and has declined significantly this year. The government successfully launched bonds with a 3 year maturity in January 2000 and a 5 year maturity in March. The yields on long-term government bonds have been steadily declining.

Reduction of the general government fiscal deficit to at least 2 percent in 2000, 1 percent in 2001, and to a broadly balanced budget over the medium term, are necessary preconditions for improving the external balance. In the short term, the fiscal target is to be achieved primarily by a tight control on the wage bill of the public sector and other expenditure control measures. The efforts to enhance tax administration have intensified as well. All indications show that the fiscal target for this year should be met.

The Latvian authorities do not underestimate the risk of the growing external imbalances and are ready to respond by further budget tightening. In a first public statement after taking office, the Minister of Finance declared his strong commitment to implement "emergency" measures in the event of further worsening of the external stance. Like the staff, he sees the fiscal deficit as a ceiling rather than a target. This is why the Ministry of Finance has created a contingency plan to be implemented immediately if the current account deficit would be higher and/or FDI would be lower than projected. This plan contains one-time measures and the partial use of certain expenditure items.

Following consultations with the staff in May, the Minister of Finance and the Minister of Economy have send letters to the staff confirming that all privatization receipts, excluding administrative costs, transfers to local governments' privatization funds and the reserve fund of Latvian Privatization Agency, will be transferred to the Treasury aiming at enhancing the transparency and efficiency of public sector operations.

The demands of EU accession are likely to put pressure on public expenditure over the medium term. Coupled with the requirement to increase defense spending associated with potential NATO accession, the government will have to find resources to finance a significant upgrading of the country's infrastructure, and, more generally, to comply with the various demands of the EU's *acquis communautaire*. Thus, streamlining and reprioritizing expenditures is the most urgent task. In this context, my authorities highly value the recommendations of the Fund/Bank technical assistance mission on public expenditure policy. With regard to medium-term fiscal planning, significant progress has been achieved in creating a "Latvian National Development Plan" aimed at efficient reallocation of both domestic (public and private) and external resources to meet the set of determined economic policy priorities.

Structural reforms and financial sector policies

According to the new government's Declaration, the large-scale privatization program is to be completed within one year. The authorities believe that the involvement of international advisors for the sale of the Latvian Shipping Company, the major energy company (Latvenergo), the oil company (Ventspils Nafta) and telecommunication operator (Lattelekom) should help ensure the use of best commercial practices and reduce political interference in the process. The privatization of utilities will be accompanied by the implementation of a "superregulatory" agency according to the law, the enactment of which is expected this year.

The authorities are carrying on an aggressive campaign to further improve the business environment. The important part of this campaign is the introduction of a policy of "zero tolerance" for corruption and money laundering, as stated in the government's Declaration. The Corruption Prevention Council, which was established about three years ago, has succeeded in enhancing transparency and cooperation among public institutions to combat corruption.

The banking sector has largely recovered after the Russian crisis and has returned to profitability. The healthiness of the Latvian banking system is justified by a number of facts. Capital requirements for banks were increased this year, reaching EUR 5 million, and all banks comply with the requirements. During 1999, Scandinavian and German banks increased their equity investment in Latvia. The increasing presence of foreign banks has promoted competition between banks and led to higher cost efficiency. Also the recapitalization process of "Rīgas Komercbanka" has been completed.

Latvia is the first country which has completed a self-assessment of compliance with the Basle Core Principles Financial of Effective Banking

Supervision. The preliminary results show that the BoL fully or largely complies with all Basle Core Principles and relevant EU banking directives.

At present, responsibility for market supervision is shared among several agencies. The central bank supervises the banking sector, while the state insurance supervision agency oversees insurance companies. Equity markets, the Riga stock exchange and investment funds are supervised by the Securities Market Commission. A new act by Latvia's parliament would consolidate supervision of financial institutions under a single agency, which begins operations on 1 July 2001. A politically independent five-member board will be appointed to head the Unified Financial Sector Supervision Agency, and its operations will be funded by the financial institutions themselves.

Latvia has been in the forefront of transition economies in pushing pension reform ahead despite strong resistance from the opposition. In mid-February, the parliament adopted the Law on State-Funded Pensions, which sets forth the principles of the establishment and operation of a state-funded defined contribution second pillar of the pension system, including general provisions for making contributions. Contributions will be collected starting July 1, 2000, gradually rising from 2 percent of income to 10 percent over 10 years. The adoption of the second, fully-funded pension pillar and the emergence of private pension funds as the third pension pillar, should help to ensure adequate retirement income and encourage private sector savings. By this year-end the government intends to submit to parliament additional amendments aimed at reducing the size of the informal labor market and enhancing social tax collection.

Mr. Mori submitted the following statement:

Since our last discussion on Latvia, developments have been favorable with the economic recovery strengthening as an accelerating real GDP growth was observed for two consecutive quarters. Nevertheless, concern remains regarding the large current account deficit which declined only marginally and with increased reliance on debt financing of this deficit. In the short-run, a cautious demand management is, therefore, key to ensure the maintenance of a sustainable external position.

As noted in the paper "The Baltics—Savings, Investment, and External Adjustment in the Face of Exogenous Shocks", as economic growth recovers over the next two years in Latvia, the private saving-investment balance can be expected to worsen. Therefore, at this stage of the economic cycle, fiscal policy needs to be managed cautiously, and further policy strengthening will be required in the event that the external current account deficit fails to decline or FDI falls short of projections. But monetary policy through an appropriate credit management has also a role to play consistent with its

foreign exchange policy objective. We concur with the staff appraisal and will restrict our comments to the monetary framework where the use of instruments seems to require some adjustment.

The Bank of Latvia needs to manage its instruments to avoid excessive volatility in the benchmark interest rate and abrupt changes in domestic credit conditions. In this regard, the Treasury's issuance of bonds in the market should ideally follow closely its cash-flow operation throughout the year to avoid market misperception. Any excess of securities issued over the Treasury's current needs simply forces the BoL to make an offsetting transaction to absorb this excess to avoid an undue contraction in domestic liquidity.

In the case of the Treasury's issuance of five-year bonds mentioned in the report, apparently the operation was not made with simultaneous intervention of the BoL which might have produced excessive contractionary effects given the magnitude of the operation. Only after a certain time lag the BoL injected liquidity by purchasing large amounts of these bonds from commercial banks, which eased domestic credit conditions. A simultaneous intervention by the BoL might have prevented the contractionary effect. In any event, we are of the view that any Treasury security issuance in the domestic market in excess of its short term-financing need should be generally very marginal. Large placements of bonds into the financial system followed by a considerable absorption of these securities by the BoL tend to make it more difficult to determine the benchmark interest rate, and perhaps the fiscal stance.

Other transactions that need to be evaluated better in terms of consistency with the monetary framework are the BoL's issuance of long-term foreign exchange swaps. This operation may be seen as external borrowing by the banks combined with a forward operation provided by the BoL, which fixes the exchange rate for the date of repayment of the credit. In this case, the foreign exchange resources obtained by the BoL in the transaction present an inconvenience in that they become a non-usable reserve since these resources are earmarked as a collateral for the repayment.

The swap operation would have the objective of fostering long-term lending in lats by commercial banks and deepening domestic financial markets that otherwise would not occur. This implies that the operation seeks to correct market imperfection by supplying the economy with longer-term lendings in domestic currency and forward foreign exchange operations, both of them not provided by the market. We share the staff's concern on this issue and their recommendation for the BoL to more thoroughly evaluate the benefits and inherent risks in this instrument. With the incentives given, there is a risk that the cumulative volume of transactions may well-exceed the level of credit compared to the supply required to correct market imperfections,

hampering, hence, monetary policy. In addition, the resources may be reallocated to transactions other than the one originally intended for.

In sum, the large issuance of Treasury bonds with a considerable absorption by the BoL and the long-term swap operation may represent obstacles for an adequate management of monetary policy. At this stage, with economic recovery and external current account concerns, the instruments for monetary policy need to be well adjusted to maintain the domestic credit conditions consistent with the macroeconomic stability.

Another issue that requires close monitoring by the authorities are the large inflows of deposits from non-residents. Here, one should prevent the use of such deposits for financing domestic activities in Latvia, by either financing the external current account deficit or reallocating credit domestically. Off-shore transactions need to be insulated from on-shore activities to preserve the integrity of the system. We understand banks have generally invested abroad in securities and other assets in OECD countries, which is a correct approach since such deposits could be prone to sudden withdrawal.

We support the proposed decision.

Mr. Lushin made the following statement:

First, let me thank the staff for well-focused papers prepared for our discussion today and Mr. Lehmussaari for his informative Buff statement. By having timely implemented prudent policy measures, Latvia has successfully overcome the recent external shock. GDP growth has resumed and all major economic indicators strengthened. Despite the real exchange rate appreciation, external competitiveness remains adequate owing to moderate growth of real wages.

Since I agree with the trust of the staff appraisal and find staff's recommendations appropriate, I will limit my comments to a few policy issues that, in my view, deserve to be mentioned.

Although the external position of Latvia is manageable, the size of the current account deficit and the fact that it is being partially financed through external borrowing is a matter of concern. I agree with the staff that improved growth prospects in the EU and CIS countries may be conducive to Latvia's exports. However, it seems to me that staff's medium-term projections for the trade balance may be overly optimistic. The staff's medium-term scenario envisages merchandise exports growth of around 12 percent while growth of imports is expected to be 9 percent. The pattern of trade performance before the Russian crisis was just the opposite: imports grew faster than exports. I am not quite sure that somewhat improved performance of Latvia's trade partners will be sufficient to reverse this trend. In any event, future strong growth may

result in further deterioration of private saving-investment balance thus putting the current account balance under pressure.

In these circumstances, and given the uncertainty about future FDI flows, the authorities cannot afford to run any significant fiscal deficit. In this light their efforts aimed at fiscal consolidation in 2000 (including the prepared set of contingency expenditure reductions) and onwards are most welcome. At the same time, some serious fiscal challenges still lie ahead. As mentioned by Mr. Lehmuusaari in his Buff, in future the demands of the EU accession and the potential NATO membership will put additional pressure on the public expenditure over the medium term. However, in 3 years between 1996 and 1999 Latvia has already increased its general government expenditure by almost 8 percentage points of GDP with its level now approaching the average level of the euro-area countries. I wonder what policies the authorities are going to pursue in order to find resources for these additional expenditures without putting the fiscal balance at risk.

Regarding monetary policy, I share staff's concern about the BoL's foreign exchange swaps aimed at fostering long-term lending in the national currency by commercial banks. This measure is equivalent to providing long-term foreign exchange guarantees, the practice that has already proved to be disastrous in the course of the Asian crisis. This way of addressing market imperfections is prone to inherent risks, and the potential benefits from such a policy should be carefully weighed against them. Therefore, I urge the staff to thoroughly monitor the developments in this area and to present a more detailed assessment of this policy during the second review of the program.

As it is stated in the staff report, considerable progress has been achieved in restoring the soundness of the banking system. It is commendable that the authorities have strengthened prudential standards and brought them close to international norms. Now, when the harmonization of the BoL's prudential framework with international standards is largely completed, I welcome the authorities' intention to create the Unified Financial Sector Supervision Agency. The consolidation of the entire financial sector supervision in one body will be conducive in bringing the supervisory standards for non-bank financial institutions, in line with international norms as well.

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

Mr. Szczuka made the following statement:

I welcome the progress made by Latvia since the last Article IV consultation and under the current Stand-By Arrangement. This progress is well documented by strong GDP growth and a favorable development in the

current account for the first quarter of this year, by the considerable improvement in the fiscal position, and by the government's actions and plans aiming at completing the privatization process and advancing other structural reforms. I broadly agree with the staff appraisal and fully support the proposed decision. Therefore, I would like to focus my remarks on issues relating to the external sector.

I agree with the staff that the large current account deficit poses a risk to Latvia's external sustainability. If not addressed appropriately, it could negatively affect the country's medium term growth prospects. There are two factors, in particular, which suggest that the size of the deficit of about 10 percent of GDP constitutes a greater threat to the stability of the Latvian economy than it would to the economic stability of Estonia or Lithuania. Latvia is the only country in this region without a formal currency board arrangement. Therefore, it is more susceptible to attacks on the currency, as has been confirmed by last year's pressures on the lats. Also, the commodity structure of Latvia's exports is not sufficiently diverse and is dominated by a few product groups with relatively low value-added, with wood products alone representing 37 percent.

The staff and the authorities are sanguine about the prospects for reducing Latvia's external imbalances. Despite the substantial appreciation of the real exchange rate by more than 40 percent since 1996, and despite a doubling of the current account deficit after 1997, there does not appear to be a major problem in the current value of the lats and the current exchange rate regime. While that might well be the case, the situation should be monitored carefully with regard to the development of Latvia's competitiveness and in view of keeping an open mind with regard to a move toward a peg with the euro and, possibly, toward a full-fledged currency board.

The staff and the authorities overemphasized the role of foreign direct investment (FDI) in expanding export potential and ensuring non-debt financing of the current account gap. While I do not disagree that FDI should and can be expected to play a major role in enhancing the efficiency of Latvia's economy, I wonder whether it is appropriate to build the whole economic strategy around the somewhat uncertain premise of large inflows of foreign direct investment. I also wonder whether it is realistic to assume that, over the medium term, FDI inflows would average at least 5 percent of GDP, even after the completion of the privatization program and despite the already substantial FDI penetration at the current stage.

The staff report identifies the main obstacles to investment in Latvia, but is less specific with regard to factors that should attract persistent FDI inflows. The staff today referred to the high coverage of the current account deficit by foreign direct investment in the first quarter, but failed to mention that the amount of investment during that period only represents ten percent of

total FDI projected for 2000 as a whole. The staff also expressed satisfaction with the composition of FDI.

With regard to the external position, could the staff explain whether it is realistic to expect that export growth will permanently exceed imports by a 2-3 percentage point margin from 2001? I also wonder which are the factors behind the projection that, despite the expected large increase in FDI, the balance of interest and investment income will improve over the medium term. The projections presented by the staff in this respect suggest that the incentives should work against rather than in favor of strong FDI. How does the staff reconcile these apparent inconsistencies in their projections?

The data published today by the Bank of Latvia show a substantial and welcome improvement in the current account position, stemming mainly from the increase in the positive balance of services. However, trade data are somewhat less favorable, and there are indications that since April the trade deficit increased by about 9 percent compared to the same period of the previous year. What is the staff's assessment of the prospects for the current account for the year 2000 as a whole, given the stronger-than-projected GDP growth and the high level of oil prices during the first quarter?

With regard to the external statistics, the footnote on page eight of the staff report mentions a level of external debt at the end of 1999 equivalent to 61 percent of GDP. That compares to an official figure of total external debt of 22 percent of GDP in table 3 on page 39 in the staff report. The large difference between the figures and the inconsistency in the terminology warrants further explanation. It is surprising that this should not have received more attention in the staff report.

On fiscal policy, I welcome the deficit reduction planned for this year and the objective of achieving a balanced fiscal position over the medium term. However, the earlier plan to adopt a supplementary budget equivalent to 0.7 percent of GDP may raise suspicions with regard to the authorities' commitment to fiscal discipline. Could the staff confirm that this plan has been abandoned? Given the lack of progress in reducing the substantial tax arrears, I would also welcome the staff's comments on the nature of these arrears and on plans for reducing them in the future.

I fully associate myself with the staff's criticism of the direct spending of privatization receipts by the LPA, and welcome the authorities' decision to discontinue this practice. It would be an understatement to consider such practices merely as backtracking on transparency, given that it constitutes an important weakness in the conduct of fiscal policy and, in particular, in the management of public expenditures.

I agree with the staff that purchases of treasury bonds by the Bank of Latvia should have been better explained or perhaps completely avoided on such a large scale. More generally, I do not see any particular need for a further relaxation of monetary policy at the current stage.

I have serious doubts as to the merits of introducing long-term foreign exchange swaps, and it is somewhat surprising that the staff was unable to convince the authorities not to introduce a questionable instrument in a policy area that lies at the core of the Fund's activities. I agree with the staff that the Latvian supervisory authorities should pay close attention to the large and growing inflow of deposits from non-residents and their impact on the risk exposure of Latvian banks.

I wish the authorities further success in consolidating their substantial achievements in the transition process and in preparing their economy for EU membership.

Mr. De Blasio made the following statement:

We welcome the improved economic situation in Latvia, we concur that the SBA is broadly on track, and would only like to address a few areas of concern.

On the current account, we agree that the authorities should be ready to consolidate fiscal policy further in the course of the year, if that should be required by external developments. In this regard, we welcome the fact that the Minister of Finance has already identified a number of contingency measures. Perhaps the staff could elaborate on the precise measures that have been identified.

The privatization program has been proceeding rather slowly. While we are glad that new impetus has now been given to that process by the World Bank's Programmatic Structural Adjustment Operation, we would like to stress that progress on the privatization agenda is going to be key, not only for badly-needed balance of payments financing but also for the overall medium term economic prospects in general. In order to reap all possible benefits of privatization, the sale of public enterprises should go hand in hand with steps to create an appropriate regulatory framework. The emphasis placed on this matter by the staff is entirely appropriate.

On the BoL's foreign exchange swaps, I concur with the cautious view expressed by the staff and by Mr. Mori and others. Also, the high level of deposits from non-residents is a reason for concern, since the domestic banking system is exposed to the risk of sudden withdrawals. With regard to the authorities' explanation cited in paragraph 38 of the staff report, I wonder about the share of banks' holdings of marketable government securities from

OECD member countries as compared to the level of deposits from non-residents. It would also be useful to learn on what basis the authorities consider such deposits as exhibiting greater stability. Even more worrisome is the fact that some of these deposits may come from “questionable sources”, in the words of the staff. In this regard, we urge the authorities to enforce the money laundering law rapidly and in a transparent manner.

We welcome the authorities' intention to publish the Article IV staff report, as well as their willingness to participate in the Financial Sector Assessment Program.

Ms. Fernandez made the following statement:

After reading the comprehensive and well-written set of papers presented by the staff, I am so glad to observe that Latvia's economic recovery appears to be on track. The authorities' implementation of prudent macroeconomic policies and the strengthening of the rate of growth in major trading partners are placing Latvia in the way to invigorate the economic reactivation that has been initiated in the last quarter of 1999, while keeping inflation subdued.

Against this background, however, progress in reducing the economy's major imbalance—that of the external current account—has been very limited and continues to be a very serious source of concern. On the other hand, the pace of implementation of the structural reform of the economy has not been as determined as it had been envisaged; several structural benchmarks for end-March were not met, thus making the results attained so far, fall short of expectations. A decisive progress in these two key areas is essential to reduce Latvia's external vulnerability and rebuild its economic growth over more sustainable grounds. Even more so, when taking into account that the strengthening of economic growth may certainly bring the risk of a worsening of the external imbalance, if it is not properly accompanied by adequate saving-enhancing measures and structural reforms.

Therefore, notwithstanding the authorities' satisfactory accomplishments attained until now—and for which they should sincerely be commended—the fact is that still much remains to be done. I am encouraged that the new government is aware of the economy's major challenges and I most welcome its expressed commitment to speed up reforms and to reinforce the process of fiscal consolidation. On this basis, as well as on the fulfillment of all prior actions required to complete the first review of the SBA, I certainly support the completion of this First Review.

I broadly share the conclusions and recommendations of the staff, so I will just make some brief comments with regards to the fiscal stance, the exchange rate and the structural reform of the economy.

I agree that the continued implementation of a tight fiscal stance has to be the keystone of the economic strategy, a fiscal stance based on expenditure reductions and stronger efforts to enhance tax administration, and not on tax increases given that the tax burden is already quite heavy. Moreover, under present circumstances, I concur it is most advisable to consider the program fiscal deficit as a ceiling and not as a target, as well as to be ready to implement the contingency expenditure reductions, were the external current account fail to develop as expected or were the FDI fall short of program estimates.

An efficient control of the public spending, as well as an enhanced transparency and accountability, will be of the utmost importance. Accordingly, the bypassing of the Treasury to spend privatization receipts by the privatization agency, in no way goes in line with the need to undertake the adequate expenditure management that is essential to implement an effective fiscal policy. In this respect, I am glad to note that the necessary steps have been undertaken to avoid similar events in the future.

Another key element, to contribute to mitigate the concerns over the sustainability of the external imbalance over the medium term, is the inflow of FDI. Unfortunately, the path it has followed so far has not been as positive as it could have been expected. Consequently, the decisive implementation of the structural reform agenda, notably the privatization process and the regulatory framework, has to be one of the authorities' priorities as it will play a crucial role in developing the necessary headway to improve the conditions that the private sector requires to enter into business.

Competitiveness has been deteriorating due to the appreciation of the real effective exchange rate vis-à-vis the major trading partners. I concur that the current exchange rate peg to the SDR has served the economy well and seems to remain appropriate. However, I would like to ask the staff to further elaborate on how it would see an acceleration of the transition to an Euro peg in the process of adhesion to the EU. It is needless to emphasize that maintaining the current exchange rate peg depends on the continued implementation of tight financial policies and a decisive structural reform agenda. Moreover, their positive effects enhancing market confidence, private sector activity and broadening the export base, will contribute to further increase competitiveness and hence the rate of growth exports.

With regards to the monetary stance, I will just associate myself with the staff and others on their doubts about the long-term foreign exchange swaps.

Finally, on financial sector issues, I most welcome the positive developments that have been registered in improving banking supervision and prudential regulation, and encourage the authorities to strengthen their efforts

in enhancing the soundness of a financial sector that nowadays appears to be generally healthy.

With these remarks, I wish the authorities well.

Mr. Merz made the following statement:

Let me first thank staff for the well-written documents and insightful background documentation allowing useful cross references to all Baltic states with regard to pension reform and external adjustment patterns. Since we are almost fully in line with staff's analysis and recommendations and can therefore also support the completion of the first review under the SBA, I can limit my remarks to four points for emphasis:

First, in light of the high current account deficit a substantial increase of foreign direct investment is of utmost importance. Box 3 of the staff document clearly describes the variety of existing obstacles for further capital inflows. We share staff's view that enhancing property rights, strengthening the judicial system, reducing possibilities for corruption, and cutting red tape should be vigorously pursued to achieve this goal. In this context, we welcome the promotion of a long-term lending market in lats and the intended removal of the remaining restrictions on foreign ownership of land.

Secondly, on exchange rate policy staff and the authorities share the view that the peg to the SDR could be maintained until EU accession. Although I have taken note of staff's indicators pointing out that the country's competitiveness is not severely hampered – also underlined by the most recent favorable balance of payments data - we have witnessed a substantial real appreciation of the lats against the euro. Against this background, ways and means to make a move to an euro peg at a somewhat earlier time should be explored, as already indicated by Mr. Szczuka and Ms. Fernandez as one possible option. Such a peg would also better reflect the trade pattern, as shown in table 48 of the selected issues document, and would reaffirm the strong willingness of the Latvian authorities to EU accession. It is needless to say that such a move has to be cautiously prepared accompanied by further pursuing of a strict stance of monetary and fiscal policy.

Thirdly, as Mr. Mori we share staff's concerns with regard to the issuance of long-term foreign exchange swaps to foster long-term lending in lats by commercial banks. Such a policy is in a certain way a subsidization of the banking sector and favors moral hazard. Staff should therefore stick to its intention to revisit the experience with such swaps at the time of the second review aiming to achieve a certain framework for such a policy.

Fourthly, we share staff's concern that the recent bypassing of the Treasury to spend privatization receipts directly by the Latvian Privatization

Agency has complicated expenditure management and reduced fiscal transparency. We therefore welcome the intention of the authorities to reverse this policy.

To conclude, we are convinced that the Latvian authorities who have successfully matched the repercussions of the Russian financial crisis will match remaining challenges and we wish them all the best.

Mr. Çakir made the following statement:

It is encouraging to see Latvian growth recovering from the recession of 1999. But the large current account deficit, the fragile political situation, and the rancorous disputes over privatization that have brought down the last two governments, are all threats to the success of program.

Current account developments during 1999 were worrisome, and the 2000 current account deficit, estimated by the staff at 8.7 percent of GDP, is still rather high and calls for further policy strengthening. We do not think the authorities should "wait and see" if the situation improves before tightening the stance of fiscal policy.

Concerning privatization, we applaud the authorities' plan to "jump start" the lagging privatization process. Can the staff tell us the reasons for the failure of two tenders for the Shipping Company? Was the price an issue? The reasons should be examined in detail to avoid any further delays in the privatization process.

In connection with long-term bond issues and foreign exchange swaps, I associate myself with Mr. Mori's concerns. Better coordination between the central bank and the Treasury are needed to avoid undesirable volatility in the financial markets.

The authorities are eager to issue long-term bonds denominated in lats. Indeed, they might wish to consider shortening the maturity of their borrowings, since successful program implementation would bring the interest rates down. In addition, we urge the authorities to seek technical assistance in cash management and in developing the primary and secondary markets for government securities.

In Table 4 of the staff report, we see that although the GDP figures for 2000 have been revised downward, the projected revenues of the consolidated government remain constant. Does this imply that the staff expects an overperformance on the revenue side?

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

Mr. Le Gal made the following statement:

The situation in Latvia has not changed much since the Board discussion in December 1999. We welcome the fact that growth prospects have improved after there had been some concern about the level of the current account deficit and the robustness of the FDI forecast. With regard to FDI, our concerns remain, and we share the staff's recommendation in favor of fiscal prudence and regard the programmed fiscal deficit as a ceiling rather than a target. We also support the intended increase in transparency in the use of privatization proceeds. With regard to the exchange rate regime and the possibility of exploring an early peg to the euro, I would like to associate myself with Mr. Mori and others.

In paragraph 26 of the staff report the staff qualifies the expenditure-to-GDP ratio as excessively high. It appears that the expenditure-to-GDP ratio can be regarded as high only relative to the revenue-to-GDP ratio. It is interesting that the more successful transition countries have generally higher expenditures and reserves than those facing difficulties. The transition process has considerable costs, and the state needs adequate means to cover them and achieve the transition successfully.

With these remarks, I support the proposed decision.

Mr. Yakusha made the following statement:

Latvia's economic performance since the second half of 1999 has been impressive. Prudent policies have led to an acceleration of growth and have improved banking sector soundness. The only area that remains a potential source of vulnerability is the current account deficit, but only when seen in combination with the exchange rate regime and the rather unconventional deposit base in certain major banking institutions.

We were pleased to learn from the staff report as well as from Mr. Lehmussaari's statement that the authorities have recently implemented a zero tolerance policy with regard to corruption and money laundering and that we may expect further improvements in banking supervision, including the unification of the supervisory authority under one roof.

The exchange rate regime currently in operation remains a cause for concern in our view, given that similar arrangements in other countries have contributed to the development of crises. The high ratio of short-term external debt to gross reserves is also a source for external vulnerability. The practice of some financial institutions to advertise their services as provisional safe havens and/or tax havens for non-residents and thereby expanding their non-resident deposit base, further increases risks for the stability of the financial sector and of the exchange rate. Therefore, we would like to reiterate the

suggestion made by Mr. Szczuka that the authorities may consider a move to a more formal currency board arrangement, if the situation were to deteriorate.

Despite progress in Latvia's main economic indicators, poverty continues to be a major problem, with more than half of the households living below the subsistence minimum. This is rather disturbing, given that Latvia is one of the most successful emerging economies. We also would like to reiterate the staff's concerns about the timeliness and the quality of the economic statistics in Latvia.

Mr. Chelsky made the following statement:

In view of the high quality of the staff report and the staff's comments in the current discussion, I will only make a few comments. On the exchange rate, I am impressed by the eagerness with which my European colleagues like to encourage exchange rate pegs to the euro and membership in EU and EMU more generally. In that context, one should bear in mind that it is more important at which level the peg is undertaken, than at which point in time the peg comes into effect. I share the concern raised by Mr. Szczuka with regard to FDI and I look forward to staff's response.

With respect to Mr. Yakusha's comments on the safe haven status of Latvia, I would be interested in the staff's reaction to the authorities' assertion that non-resident deposits exhibit greater stability than deposits from residents, and the extent to which they have been able to validate that assertion as well as causes for that.

Ms. Lundsager made the following statement:

On the whole, we feel reassured that the Latvian authorities are exercising prudent fiscal and monetary policies following the resumption of growth in the second half of 1999. Latvia's willingness to control expenditures and balance the budget is encouraging. The authorities' attention to trade reforms, recognizing that growth is promoted by an overall positive economic environment, is particularly welcome.

There are a few items of concern but the large current account deficit in one. We encourage Latvia to keep a close watch on the exchange rate regime. The staff report noted that exports had grown under this regime, but the size of the current account deficit and relatively low reserve levels raise concerns:

I noted that Estonia has chosen a Euro peg. With Latvia setting EU accession at the top of its agenda, would it be appropriate to start planing the transition to that anchor, especially given the growing share of EU trade in Latvia?

Also, there is a keen desire to promote more FDI, which can be encouraged or deterred by a given exchange rate regime – the benefits of a rock solid peg must be weighed against the impact that the peg has on Latvian costs of production relative to other investment locales, particularly if FDI is aimed at producing exports, as was noted in the ‘Selected Issues’ paper. That discussion emphasized the role of the business environment for encouraging FDI, which I agree is critically important, but I would also be interested in staff thoughts on the role of the exchange rate in promoting inflows. For these reasons, we urge continued close attention to sustaining competitiveness.

Let me add that I recognize the authorities’ strong commitment to sound macroeconomic policies and welcome their preparation of contingency measures and their steps taken to control the transfer of privatization proceeds. Action on pension reform is also important. The reported compliance with Basle Core Principles was good news and we congratulate Latvia on its intention to publish the Article IV staff report in its entirety and its adherence to SDDS.

I have one final question for staff related to the missed end-December performance criterion, which was quickly rectified. This is a precautionary program, no drawing was planned. But, how would the IMF have characterized performance in the early months of this year, before it was clear end-March ceilings would be respected? How would Fund staff have responded to inquiries during that period? Is the Board typically notified when countries with precautionary programs miss performance criteria? I presume if a country wished to draw they would seek a waiver, but in other cases, when a precautionary program is aimed at sustaining market confidence in a country, what would be the practice?

The staff representative from the European II Department, responding to questions relating to fiscal policy, explained that the assumptions underlying the staff’s projections for revenue had not changed. However, as nominal GDP had been lower than expected in 1999, there was a lower base for the GDP projections for 2000. The reason why this did not lead to a lowering of revenue targets in 2000 was the fact that the revenue-to-GDP ratio was higher than expected in 1999. Therefore, a downward adjustment of the 2000 revenue target was not necessary. At the current stage, actual revenue was in line with the target. However, revenues in May were about 6 percent higher than in the same period in 1999.

With regard to a question on contingency measures raised by Mr. De Blasio, the staff representative noted that a number of specific measures had been identified that could prevent an overshooting of fiscal targets, if revenues were to fall short of current projections. Those measures included cuts in specific purchases of goods and services, funding of specific projects scattered among a number of ministries, reductions in public investment, forgoing one round of pension indexation, and, should all that prove insufficient, the authorities would resort to across-the-board cuts that would affect all ministries equally.

Responding to a question from Mr. Lushin about possibilities for reducing expenditure levels, the staff representative said that it was government policy to aim at reducing the expenditure-to-GDP ratio. In this context, there had recently been a joint mission by Bank and Fund staff exploring the options for reducing expenditure. Reductions would need to take place in the area of pensions, and agreement had been reached with the authorities on a number of measures aimed at controlling pension spending that would be put forward before the end of the year. Possibilities for lowering expenditures had been identified in the joint staff report in education, as the number of students was expected to decline, and in employment policy. Also, the government was currently conducting a number of functional reviews of ministries to examine the scope for reductions in public employment over time. However, some of the measures identified so far, especially those in the area of pensions and health care, would bring about a lowering in spending only over the medium term. Therefore, dramatic reductions in the expenditure-to-GDP ratio could not be expected in the period ahead but only over time.

Responding to questions on monetary policy, particularly with regard to concerns raised about the causes of and the potential effects of non-resident deposits, the staff representative observed that the data did not bear out the suggestion that non-resident deposits had been less stable than other deposits recently. There were no detailed data available on the share of non-resident deposits that were invested in government securities from OECD member countries. The Bank of Latvia had informed the staff that those deposits had not been used in significant amounts for domestic lending. That seemed to be reflected in the balance sheet of the banking system, where one could observe parallel increases both in assets and liabilities and thus a broadly unchanged position of net foreign assets.

Responding to concerns with regard to the origin of non-resident deposits, the staff representative informed that the Latvian authorities had taken significant steps to fight money laundering. The Money Laundering Law had been in effect since the middle of 1998, and regulations and disclosure procedures were in place for monitoring their implementation. A staff mission from the Fund's Monetary and Exchange Affairs Department had found that laws and regulations were in compliance with the Basel Core Principles. The Bank of Latvia was taking a number of additional steps to strengthen compliance further, including putting in place a law requiring banks to have more complete information about the risk structure of their client base. The OECD's financial action task force had visited Latvia recently and would produce its report shortly. The Bank of Latvia had apparently been pleased with the meetings in that context. In the area of money laundering the appropriate implementation of laws and regulations was crucial, and the significant number of cases that had already been brought before the prosecutor appeared to indicate that further progress was being made in that regard.

Responding to questions on the exchange rate regime, in particular on those relating to a possible peg of the lats with the euro earlier than currently envisaged by the authorities, the staff representative said that the staff supported the authorities' view that the existing peg worked well and that the eventual transition to a peg with the euro would have to be initiated with great care and only once the level of the exchange rate was deemed appropriate. It was not clear, at the current stage, what the appropriate level of the exchange rate would be. Even

if the euro were currently at a long term equilibrium level, the gains from a move to a euro peg at the current stage would not be large, partly because the currency weights in the SDR were not significantly different from the regional composition of Latvian foreign trade. In recent years, the lats had remained within a 15 percent band of the ecu and later the euro, and there had been little fluctuation of the lats within that band. With regard to competitiveness, the staff shared the view that the situation needed to be monitored closely, although it appeared that, at the current juncture, the lats was still competitive. If that situation were to change, pegging the lats to the euro at an earlier stage before EU accession could be considered.

Mr. Yakusha wondered whether, in view of the risks that the staff had mentioned, it would be prudent for the authorities to aim for a higher level of external reserves.

The staff representative from the European II Department responded that the level of net reserves was not a policy target. However, the current level of net reserves equivalent to about three months of imports, was sufficient.

Responding to questions about the staff's projections regarding exports and foreign direct investment, the staff representative considered that those projections did not appear to be overly optimistic. As far as FDI was concerned, the staff had projected a gradual decline in FDI as share of GDP. The projections were rather cautious, given that a number of large privatization projects were still going to take place over the next years, which would have direct implications for FDI inflows and for follow-up investment. Also, EU accession would make Latvia more attractive to foreign investors. However, the staff shared the view expressed by a number of Executive Directors that FDI depended to a large degree on prudent government policy, and in particular on removing remaining administrative barriers to private sector activity. The staff's projections were thus conditional on appropriate policies being implemented by the authorities in the period ahead.

With regard to export and import projections, the staff representative observed that exports had by no means continuously grown more slowly than imports; 1997 was an example of the contrary. Then, exports had grown by 24 percent, while imports had only increased by 17 percent over the previous year. The staff's projections suggested that imports would grow in line with nominal GDP. Exports were expected to grow somewhat faster, owing to a modest increase in market share in the European Union and to a small recovery in exports to the CIS, which had declined precipitously during the previous 18 months. In the staff paper on the sustainability of the exchange rate regime in the Baltics, which had been prepared for the previous Board meeting, the staff had examined various scenarios for different export performances. In that paper the staff had argued that, even with exports at 25 percent below the baseline projection, the external position would still remain sustainable, reflecting, in part, slower economic growth.

On the current account projections in general, the staff representative pointed out that, over the next several years, the current account would improve by less than would be implied by the projected fiscal consolidation. There would be a small deterioration in the private savings and investment balance over the next several years, and in the medium term, the

current account was expected to have returned to the position it had prior to the Russian crisis. While such a performance depended on the appropriate policies being followed by the authorities, it was achievable.

Responding to a question on the staff's growth projections and the impact of stronger growth on the current account, the staff representative informed that they had not been altered for the current year. The staff expected to see the economy grow by about four to five percent in the first quarter, which was not significantly higher than had been anticipated, given that growth in the first quarter of 1999 had been subdued. Fiscal arrangements under the program would address the impact of stronger growth on the current account, given that all additional revenues above program projections would be dedicated to further deficit reduction.

With regard to the definition of debt, a question raised by Mr. Szczuka, the staff representative remarked that the distinction between the broader definition and the more narrow definition had two reasons. The staff had considerable doubts about the broad debt measurement, given that the BIS data and the international investment position data obtained from the Latvian authorities differed considerably. The staff had examined the causes for that extremely large discrepancy between BIS and official data with the help of an advisor in Latvia. More generally, it appeared that the broadest definition of debt gave an overly pessimistic impression of Latvia's vulnerability, owing to the fact that it included the non-resident deposits which, as the staff had mentioned before, were effectively matched by holdings of foreign assets abroad. On a net basis, debt was rather low in Latvia, and short-term debt was actually negative. Hence, the fact that the staff report included various definitions of debt reflected the intention to provide Directors with the complete picture of the debt situation.

On structural issues, and in particular on the question raised by Mr. Çakir as to why the tenders for the shipping company had failed in the past, the staff representative explained that, initially, mistakes had been made with regard to pricing. Subsequently, the terms of the privatization had been altered in such a way as to render the purchase unattractive despite moving to a more realistic price range—for example by the government's insistence on retaining a so-called "golden share." However, the staff was confident that the process had been made more transparent and that there would be significant interest for the company at the next occasion.

With regard to a question raised by Ms. Lundsager relating to the performance criteria that had been missed, the staff representative noted that the slippage in question had been addressed swiftly by the Bank of Latvia. Given that the arrangement was of a precautionary nature, and given that Latvia had not wished to make a purchase, there was no formal mechanism for informing the Board about the slippages at an earlier stage. The end-March 2000 performance criteria had all been met, which had been reflected in the staff report along with the fact that performance criteria for end-December had been missed. At that time, the staff had not reported the slippage, given that no purchase had been associated with the fulfillment of the criteria.

The staff representative from the Policy Development and Review Department informed that it was the general practice not to produce a separate report if a country missed a performance criterion, unless the country wished to make a purchase. If that were the case, a waiver would be needed, and the staff would prepare a paper for the Board to explain the situation. In the particular case of Latvia it appeared in early 2000 that the authorities would fulfil the performance criteria for March 2000, and that the slippages had been the consequence of the Y2K issue. The staff had attempted to estimate the Y2K effect on the demand for currency and other financial assets but clearly the staff and the authorities had underestimated this effect. However, the authorities had taken the appropriate steps to correct the situation immediately after the turn of the year, and the performance criteria for March had been met.

Mr. Hendrick noted with interest that notification of the Board was not required if performance criteria were missed in case of a precautionary arrangement, and if purchases were not intended. That matter was of particular interest to his chair, given that a country in the chair's constituency was in the same situation as Latvia. It was somewhat surprising to learn that there was no need to inform the Board about such a slippage, given that staff and management appeared to have suggested the contrary in the case of the country in his constituency, and as it had been his understanding that a report would be required.

The staff representative from the Policy Development and Review Department clarified that the Board had been informed about the fact that a performance criterion had been missed also in the case currently before the Board. That information was contained in the staff report under discussion. However, in a case such as that of Latvia, where no purchase had been requested, the staff was not required to prepare a separate Board paper for the sole purpose of informing the Board that a performance criterion had been missed. There were other possibilities of informing the Board, for example through an informal session on country matters, if the program were significantly off-track. In the case currently under discussion, the staff had come to the view that the program was not significantly off-track, and that the deviation related to the Y2K problem would unwind practically by itself.

Ms. Lundsager remarked that she had been under the impression that the presumption was that the Board would be informed through an informal country matters session, if a program were off-track. It appeared important that the information was transmitted to the Board, particularly in the case of a large or a medium-sized country attracting private capital inflows. Given the potential market impact of such information, the Board should know about developments of that kind in any case. There was a need to consider carefully whether the procedure for providing that information should be uniformly applied to all countries, or whether there should be a differentiation depending on whether an arrangement was precautionary, whether the private sector was involved, and with regard to other criteria of a similar nature.

Mr. Szczuka considered that the explanation given by the staff with regard to the debt figures was not entirely convincing, and further elaboration on that matter would be welcome. It was not acceptable for the Fund to use selectively net and gross figures, particularly with regard to ensuring comparability with the data provided by other countries.

It was not unusual to include trade credits and credits extended by direct investors in those data.

The Acting Chairman considered that, if Directors were satisfied with the explanation the staff representative had given on the possibility of a move to a euro peg, he would not include the matter in the summing up.

Mr. Hendrick wondered whether the staff could clarify the reasons for not requesting a waiver of performance criteria retroactively in the letter of intent in the case of Latvia.

The staff representative from the Policy Development and Review Department responded that a waiver was needed in cases where the authorities wished to make a purchase related to a performance criterion that had been missed. In the case of Latvia, that would have applied, if the country had intended to make a purchase related to the end-December performance criteria at some point between January and March. Given that that had not been the case, the end-December performance criteria lost their relevance, at end-March, when the performance criteria for end-March had come into effect. These performance criteria had been met. Consequently, the country was entitled to make all purchases that had been made available up to end March under the arrangement. Therefore, there was no need for a waiver given that Latvia was currently in compliance with the program.

Mr. Chelsky wondered how the Latvian case differed from that of Thailand, where the Board appeared to have been unanimous in the view that it was irrelevant whether the country wished to make a purchase under the program and that a waiver had to be requested in any case where a performance criterion had been missed.

The staff representative from the Policy Development and Review Department responded that the staff would need to review the case of Thailand before that question could be answered comprehensively. With the exception of informal sessions on country matters, formal notification of the Board about missed performance criteria was not required, unless the country made a request for a waiver. Given that, in the case of Latvia, the authorities did not want to make a purchase related to December performance criteria, there was no need to inform the Board. Currently, the authorities could make a purchase, given that the end-March performance criteria had been met. With regard to the difference to the case of Thailand, the performance criteria that Thailand had missed were part of a set of criteria at the final review of the arrangement. Therefore, in the case of Thailand, the Board discussion was the last opportunity to address the issue in the context of the arrangement. Directors wanted the public information notice to fully disclose the situation and felt that it was inconsistent to complete a review while the member still could not draw because no waiver had been granted. In the case of Latvia, a new set of performance criteria—those for end-March—had come into play since end December, and the data for end March showed that those criteria had been met—unlike in the case of Thailand. Thus, Latvia could make all available purchases under the arrangement upon completion of this review. The case of Thailand was therefore not directly comparable to that of Latvia, given the differences in circumstances.

Mr. Chelsky considered that, at the Board discussion on Thailand, the staff had expressed the opinion that, given that no purchase had been intended by the authorities, there was no need for them to request a waiver. The Board had expressed concern with regard to that position and suggested that the authorities should request a waiver regardless of whether they intended to make a purchase. In terms of the spirit of that discussion, it did not appear to be relevant whether there would be subsequent reviews. The key issue was rather that there should be no difference with regard to the requirement of requesting waivers between precautionary and non-precautionary arrangements. However, the issue warranted further consideration.

The staff representative from the Policy Development and Review Department responded that the staff would reexamine the issue. He clarified that the distinction he had made had not been between a precautionary and a non-precautionary arrangement. Rather, the crucial distinction lay in the question of whether the authorities needed to request a waiver in order to draw on the resources that were currently available under the arrangement. For Latvia that was not the case. At the current stage, they were in compliance with the end-March 2000 performance criteria and could make all available purchases under the arrangement upon completion of this review. That had not been the case with regard to Thailand. Had the Thai authorities wished to make a purchase under their arrangement, they would have needed to be granted a waiver. In the case of Thailand, the core question appeared to be how the status of the Fund-supported program could be adequately presented to the external community. In the case of Latvia, the situation was clear, as the authorities could make a purchase under the arrangement. That had not been the case in Thailand.

Mr. Lehmuusaari made the following concluding statement:

I would like to note that there was no major disagreement between the Latvian authorities and the staff except for the issue of the foreign exchange swaps. The amount of swaps auctioned so far has been relatively small, and this practice will be examined again in the next review. At that stage we should have more information than at present about risks and advantages of that instrument.

The question of whether Latvia should peg its currency to the euro at the current stage or before the country joins the EU is an extremely complex issue. The authorities have carefully studied the situation and have come to the conclusion that, at the current stage, such a change in the peg is not warranted. And if Mr. Mussa's view on the euro-dollar rate represents an accurate forecast, it is indeed advisable for the authorities to retain the current peg and to reassess the situation at a later stage. It is interesting to note that the three Baltic states all have fixed exchange rate regimes, but opted for different pegs.

With regard to EU accession, the Latvians are expected to be part of the second round of countries acceding to the EU. Considerable progress has

already been made with the preparations and a joint committee has been established with EU officials, which assesses the economic situation.

On the financial sector, Latvia has applied for FSAP participation, and it is hoped that this could take place in early 2001, which should provide additional information on the financial sector for the next Article IV consultation. Also, Latvia was the first country which performed the self-assessment of compliance with the Basel Core Principles, which was then evaluated by an outside expert as having been extremely positive.

With regard to FDI, it is difficult to determine whether and for how long FDI inflows will remain as strong as they have been so far. The EU accession process should bode well for continued strong FDI, and that should also be the case when Latvia eventually adopts the euro. Latvia, along with the other Baltic countries has the advantage of a flexible labor market, and they are closely connected to the Nordic countries, as can be seen in the banking sector. All of this seems to suggest that there are good chances for FDI to remain strong. The action plan to improve the business environment in Latvia is yet another positive factor that has to be taken into account in this connection. The authorities have adopted a mandatory second pillar to the pension system, which is another step forward.

I would like to commend the staff for the papers, in particular for the paper on pensions that we found extremely useful.

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

Executive Directors agreed with the thrust of the staff appraisal. They noted that the recession triggered by the Russian crisis had come to an end. Latvia had weathered this external shock, owing largely to the appropriate economic policies pursued by the authorities during the transition years in general, and in the wake of the crisis in particular. A long-standing commitment to macroeconomic stability had enabled Latvia to survive the economic downturn without a serious challenge to its exchange rate regime. Furthermore, earlier structural reforms had largely succeeded in creating a flexible market economy, allowing a relatively quick economic recovery.

Directors emphasized that Latvia's growth prospects over the medium term were promising, provided the authorities continue to pursue appropriately tight financial policies, improve further the efficiency of the public sector, and remove the remaining impediments to private sector activity. This approach would also help produce a reduction in the persistently large external current account deficit, which, together with the decline in foreign direct investment in the wake of the Russian crisis, posed a potential risk to Latvia's external sustainability.

Directors commended the authorities for their tighter fiscal stance, noting the authorities' commitment to maintaining the fiscal deficit at or below 2 percent of GDP in 2000, and 1 percent of GDP in 2001. Directors viewed these deficits as ceilings rather than targets, and supported strongly the authorities' intention to return to a balanced budget at faster pace than now targeted, if external developments were to prove worse than expected. They welcomed the identification of contingency spending measures to help achieve this objective. They also encouraged the authorities to continue their prudent budget execution, and to implement measures intended to improve tax administration and enhance the efficiency and effectiveness of public spending. They welcomed the authorities' decision to transfer privatization receipts directly to the Treasury, rather than allowing the privatization agency to spend them.

Directors commended the authorities for the progress made in pension reform and for putting the finances of the Pension Fund on a more solid footing. They also commended the authorities for the recent adoption of the second, fully-funded pension pillar and the emergence of private pension funds as the third pension pillar, which, taken together, should help ensure adequate retirement income and encourage private savings.

Directors generally agreed that the current exchange rate regime remained appropriate in present circumstances. They emphasized, however, that this was predicated on structural reforms and the maintenance of sufficiently tight financial policies, and should be carefully weighed against a potential erosion in Latvia's competitiveness that could result from a continued appreciation of the lats against the Euro. Directors observed that the Bank of Latvia's monetary policy had been appropriate in supporting its exchange rate objective. Some Directors expressed reservations about the recently-introduced long-term foreign exchange swaps, which carry inherent risks, and were concerned that these, together with the purchase by the Bank of Latvia of Treasury bonds, could complicate the task of monetary policy.

Directors commended the authorities for their determination in restoring the soundness of the banking system, but emphasized that there was no reason for complacency. In particular, Directors stressed the need to monitor carefully credit expansion by banks so as to ensure that loan quality, the extent of loan loss provisioning, and banks' risk management remained adequate. In the same vein, Directors encouraged the Latvian authorities to continue to monitor carefully the large inflows of deposits from non-residents. They welcomed the considerable progress made in bringing the prudential framework closer to full compliance with the Basel Core Principles of Effective Banking Supervision. Directors stressed that, with the improvement in banking supervision, more emphasis needed to be placed on enhancing the regulatory framework and the supervision of nonbank financial institutions.

The forthcoming Unified Financial Sector Supervision Agency would need to maintain the high quality standards set by the Bank of Latvia.

Directors welcomed the government's intention to complete the privatization of the remaining large public enterprises by end-March 2001, establish an adequate regulatory framework for utilities, and remove the remaining impediments to private sector activity so as to create an enabling business climate. While some delays had occurred in these areas, Directors considered the recent steps as appropriate in providing new impetus to completing the restructuring of the Latvian economy. They commended Latvia for its open trade regime, and welcomed the authorities' ongoing trade liberalization efforts.

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

The Acting Chairman made the following points relating to the discussion on the first review under the Stand-By Arrangement:

Executive Directors noted the overall successful implementation of the economic and structural policies under the program, including the observance of all performance criteria for end-March 2000.

While the outlook for a strong economic recovery in a low-inflation environment is promising, Directors expressed concern about the potential risks to Latvia's external sustainability. In particular, they reiterated that the fiscal deficit targets for 2000 and 2001 should be considered as ceilings rather than targets, and that the authorities should stand ready to tighten fiscal policy further, if needed. Directors also encouraged the authorities to take decisive steps to reduce significantly the expenditure-to-GDP ratio, which is high by international standards, and to create some room for the expected additional spending related to EU accession.

Directors welcomed the authorities' decision to end the recent bypassing of the Treasury, which had resulted in direct spending on privatization receipts by the Latvian Privatization Agency. This practice had seriously complicated expenditure management, reduced the transparency of budgetary procedures, and impaired the implementation of macroeconomic policies.

In the area of monetary policy, Directors emphasized the importance of absorbing any liquidity injection resulting from the auctioning of the newly-introduced long-term foreign exchange swaps. Directors were concerned about the inherent risks in this instrument, and welcomed the Bank of Latvia's willingness to critically assess its further use in the coming months, in the light of experience gained with it, and especially with respect

to the instrument's ability to foster long-term lending in lats and to deepen domestic financial markets.

The Executive Board took the following decision:

1. The Republic of Latvia has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for the Republic of Latvia (EBS/99/202, Sup. 2, 12/15/99) and the second paragraph of the letter dated November 10, 1999 from the Minister of Finance and the Governor of the Bank of Latvia.

2. The letter dated June 15, 2000 from the Minister of Finance and the Governor of the Bank of Latvia, with annexed memorandum, shall be annexed to the Stand-by Arrangement for the Republic of Latvia, and the letter dated November 10, 1999 from the Minister of Finance and the Governor of the Bank of Latvia shall be read as supplemented by the letter dated June 15, 2000 from the Minister of Finance and the Governor of the Bank of Latvia, with annexed memorandum.

3. Accordingly, the performance criteria for September 30, 2000 and December 31, 2000 set forth in paragraph 3(a) of the Stand-by Arrangement for the Republic of Latvia shall be as set forth in Table 2 and Annexes I to IV to the memorandum annexed to the June 15, 2000 letter.

4. The Fund determines that the first review contemplated in paragraph 3(c) of the Stand-by Arrangement for the Republic of Latvia has been completed. (EBS/00/109, 6/15/00)

Decision No. 12225-(00/65), adopted
June 30, 2000

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/64 (6/28/00) and EBM/00/65 (6/30/00).

5. ALBANIA—POVERTY REDUCTION AND GROWTH FACILITY—THIRD ANNUAL ARRANGEMENT AND EXTENSION OF COMMITMENT PERIOD

1. The Government of Albania has requested (i) the third annual arrangement under the three-year Poverty Reduction and Growth Facility arrangement, and (ii) and extension of the commitment period from May 12, 2001 to July 31, 2001.

2. The Fund has appraised the progress of Albania in implementing economic policies and achieving the objectives under the program supported by the second annual arrangement, and decides that the Interim Poverty Reduction Strategy Paper set forth in

EBD/00/41 provides a sound basis for development of a fully participating PRSP, and for Fund concessional assistance under the PRGF.

3. The Fund approves the third annual arrangement set forth in EBS/00/111.
4. The Fund extends the commitment period of the three-year arrangement under the Poverty Reduction and Growth Facility approved for Albania on May 12, 1998 (EBS/98/77, Supplement 1) to July 31, 2001 (EBS/00/111, 6/16/00).

Decision No. 12226-(00/65), adopted
June 29, 2000

**6. 2000 REGULAR ELECTION OF EXECUTIVE DIRECTORS—
COMPOSITION OF COMMITTEE ON RULES**

The Executive Board approves the proposed composition of the Committee on Rules as set out in EBD/00/52 (6/26/00).

Adopted June 28, 2000

**7. JOINT COMMITTEE ON REMUNERATION OF EXECUTIVE
DIRECTORS—SUBMISSION OF REPORT TO BOARD OF GOVERNORS**

1. Section 14(e)(ii) of the By-Laws states that Reports of the standing Joint Committee on the Remuneration of Executive Directors and their Alternates shall be submitted to the Board of Governors for a vote on any recommendations contained therein without meeting in accordance with Section 13 of the By-Laws.
2. The Board of Governors is therefore requested to vote upon the recommendations of this Committee without meeting, pursuant to Section 13 of the By-Laws of the Fund.
3. The Secretary is authorized and directed to send on Friday, June 30, 2000. To each member of the Fund by airmail or other rapid means of communication the Report of the standing Joint Committee to the Board of Governors together with a letter of transmittal that includes the following points:
 - a. The standing Joint Committee on the Remuneration of Executive Directors and their Alternates has adopted a Report and recommendations to be submitted to the Board of Governors. The Joint Committee neither discussed with nor disclosed to Executive Directors its Report and recommendations prior to their transmittal to the Governors. At the request of the Joint Committee, the Secretary is transmitting its Report and recommendations.
 - b. The Board of Governors is requested to vote without meeting, pursuant to Section 13 of the By-Laws of the Fund, on the two Resolutions attached to the

Report. The Executive Board decided, pursuant to Section 13(d) of the By-Laws, that no Governor shall vote on the Resolutions until July 7, 2000.

c. To be valid, votes on the Resolutions must be cast by Governors or Alternate Governors and must be received at the seat of the Fund on or after Friday, July 7, 2000, but not later than 6:00 p.m., Washington time on Monday, August 14, 2000. Votes received before July 7, 2000, or after Monday, August 14, 2000, will not be counted.

d. No particular form of vote is required, so long as the Fund receives a clear indication whether the Governor approves or disapprovesthe proposed Resolution, the response having been signed by the Governor or Alternate Governor, or there being a clear indication that the Governor or Alternate Governor has given instructions that his vote be transmitted by the sender.

4. All votes cast pursuant to this decision on the proposed Resolution shall be held in the custody of the Secretary until counted. As soon as practicable after the poll is concluded, the Secretary shall canvass the votes on the proposed Resolution and report thereon to the Executive Board. Any Executive Director may challenge the report or the status of any vote counted or disqualified, in which case the Executive Board shall determine the result of the vote.

5. The effective date of the Resolution of the Board of Governors shall be the last day allowed for voting.

6. The Secretary is authorized to take such further action as he shall deem necessary or appropriate in order to carry out the purposed of this decision.

Adopted June 29, 2000

8. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director, by Advisors to Executive Directors, and by Assistants to Executive Directors as set forth in EBAM/00/91 (6/28/00) is approved.

9. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director, as set forth in EBAP/00/78 (6/29/00) is approved.

APPROVAL: April 26, 2001

SHAIENDRA J. ANJARIA
Secretary