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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 99/78

10:00 a.m., July 21, 1999

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Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
	S.M. Al-Turki
A. Barro Chambrier	T.-M. Kudiwu, Temporary
	P. Charleton
	J.L. Pascual, Temporary
	E. González-Sánchez, Temporary
	W. Szczuka
	W.-D. Donecker
N. Eyzaguirre	P. Cabezas, Temporary
	J. Spraos
	O.-P. Lehmussaari
K.-T. Hetrakul	C. Harinowo
W. Kiekens	A. Jacoby, Temporary
	M. Sobel, Temporary
	P.A. Brukoff, Temporary
J.-C. Milleron	S. Le Gal, Temporary
	E. Jourcin, Temporary
A. Mirakhor	M. Daïri
	T. Belay, Temporary
A.V. Mozhin	A. Lushin
	H. Hagan, Temporary
M. Portugal	
A.S. Shaalan	A.F. Al-Faris
	S.K. Keshava, Temporary
	I.-K. Cho, Temporary
	Luo Y., Temporary
	Wang X., Temporary
	Y.G. Yakusha
	K. Harada, Temporary
	S. Hinata, Temporary

J. Prust, Acting Secretary
C. Andersen, Assistant
N. Hairfield, Assistant

Slovak Republic—1999 Article IV Consultation
Staff representatives: Feldman, EU1; Kapur, PDR

Czech Republic—1999 Article IV Consultation
Staff representatives: Artus, EU1; Kapur, PDR

Mauritania— Enhanced Structural Adjustment Arrangement
Staff representatives: Alonso-Gamo, MED; Kapur, PDR

Also Present
IBRD: C. Silva-Jauregui, Europe and Central Asia Regional Office; M.J. Saponara, Africa Regional Office. Asia and Pacific Department: U. Ramakrishnan. European I Department: J. Artus, Deputy Director; A. Cebotari, K. Christou, R. Feldman, B. Guerami, R. Glennerster, V. Haksar, T. Laursen, N. Mates, R. Nord. External Relations Department: L. Mboto Fouda. Fiscal Affairs Department: P.S. Heller, Deputy Director; M. Cangiano, S. Symansky. Middle Eastern Department: P. Chabrier, Director; D. Burton, Deputy Director; P. Alonso-Gamo, S. Bazzoni, J.E. Brown, V. Fichera, N. Ltaifa, K. Nashashibi, P. Tumbarello, R. Valdivieso, M. Zavadjil. Monetary and Exchange Affairs Department: M. Khamis. Policy Development and Review Department: T. Dorsey, U. Jacoby, I. Kapur, B. McDonald, S. Singh. Secretary's Department: P. Gotur, B.A. Sarr. Treasurer's Department: M.M. Cuc. Western Hemisphere Department: T. Ter-Minassian, Deputy Director; S. Mackenzie, B.M. Traa. Office of the Managing Director: S. Tiwari. Advisors to Executive Directors: M. Askari-Rankouhi, J.A. Costa, I. Dragulin, J.C. Estrella, S.S. Farid, J. Jonáš, H. Mori, Y. Patel, O. Schmalzriedt, S. Thiam, T. Turner-Huggins, S. Zádor, F. Zurbrügg. Assistants to Executive Directors: E. Azoulay, S.A. Bakhache, M. Carlens, V. Dhanpaul, N. Goffinet, T. Hadded, M.R. Hajian, M.S. Hililan, I.C. Ioannou, N. Joicey, K. Kask, E. Kornitch, J. Mafararikwa, W.C. Mañalac, W. Merz, B. Repanšek, V. Rigász, J.N. Santos, J. Schaad, C.-P. Schollmeier, Vongthieres O., R.P. Watal.

1. SLOVAK REPUBLIC—1999 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1999 Article IV consultation with the Slovak Republic (SM/99/155, 7/2/99). They also had before them a paper on selected issues in the Slovak Republic and a statistical appendix (SM/99/160, 7/7/99).

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

> This statement describes economic and policy developments since the staff report (SM/99/155, July 2,1999) was prepared. The staff appraisal in the report remains appropriate.
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> On fiscal policy, most of the measures contained in the government's new package announced on May 31, 1999 have now been approved. The import surcharge came into effect on June 1, 1999, administrative prices were increased significantly on July 1, 1999, and parliament approved almost all other revenue measures, including the increase in the lower VAT rate to 10 percent as of July 1, 1999 (and to 12 percent as of January 1, 2000), as well as the amendments to the law on social assistance needed to rationalize and reduce outlays for income support programs. However, passage of legislation to implement the motor vehicle tax and to reduce unemployment and sickness benefits has been delayed, though the authorities have indicated that passage should take place by end-September 1999. The effect of these delays on fiscal revenue and expenditure is expected to be small, and the government has reiterated its commitment to meet the deficit target for the state budget of Sk 15 billion by undertaking, as needed, across-the-board proportional cuts in discretionary spending from budgeted amounts. On this basis, staff is of the view that the authorities in 1999 will be able to keep the general government deficit to no more than 3 percent of GDP and achieve the desired reduction in the external current account deficit, as targeted.
>
> The government's new fiscal package has led to favorable developments in financial markets. The currency had declined to a low of Sk 47.3 per euro in mid-May 1999 but, in the face of supportive foreign exchange market intervention and higher domestic interest rates, the koruna strengthened somewhat in the last half of that month. Since end-May 1999, the National Bank of Slovakia (NBS) has not intervened in the foreign exchange market in support of the koruna, which has held steady near its end-May level (and equaled Sk 45 per euro on July 16). Meanwhile, one-month interbank interest rates have declined from about 24 percent in the second half of May to less than 15 percent in mid-July. On June 9, Slovakia successfully placed a five-year Eurobond for e350 million at a spread of 420 basis points above comparable German securities. The issue was augmented by e50 million on June 23 at a spread of 415 basis points and, more recently,

spreads in the secondary market have declined to about 300 basis points. Encouraged by such developments, the government announced on July 12 another augmentation of e100 million.

On monetary policy, the NBS has revised its monetary program for 1999. The revision reflects a scaling down of real economic growth to 2 percent (from the previous official forecast of 3 percent growth on a year-average basis, and compared with the Fund staff projection of 0.7 percent). In addition, the monetary program is now based on end-period CPI inflation (adjusted to exclude prices under administrative control, the effects of indirect taxes, and food prices—or the so-called net inflation) of 6–7.5 percent, compared with 5–7 percent before. The new (adjusted) CPI target corresponds to a headline rate of inflation of 13.5–15.5 percent. This is higher than the target for headline inflation indicated in the staff report: higher-than-expected increases in administered prices, which took effect on July 1, 1999 are estimated to raise the price level by about 5 percentage points. With the projected increase in velocity, the monetary program now envisages broad money growth of 6.0–8.8 percent in 1999, compared with 6 percent earlier.

Recently released data are broadly consistent with staff projections.

Real GDP in the first quarter of 1999 was 1.8 percent higher than a year earlier. Domestic demand declined by 4 percent over this period, with investment down 13 percent and private consumption up 2.3 percent.

Year-on-year headline CPI inflation was 7.1 percent in June 1999 after 6.7 percent in May and 7.1 percent in the previous month.

The merchandise trade deficit in the first 5 months of 1999 was US$659 million, compared with US$901 million in the same period of the previous year and US$1 billion for 1999 as a whole in the staff's adjustment scenario. The trade deficit is expected to narrow as 1999 progresses, reflecting the impact of the fiscal package (including the import surcharge) and lagged effects from exchange rate depreciation.

On technical assistance, the Fiscal Affairs Department has scheduled missions in September 1999 in the areas of tax administration and expenditure control.

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

Domestic investment increased from 28 percent of GDP in 1995 to almost 40 percent in 1996, 1997, and 1998. This, together with easy access to foreign capital markets, resulted in high growth in these years. But because the

GDP share of consumption did not change, the current account deficits never fell below double digits.

This situation was unsustainable, because the deficits were mostly financed by foreign borrowing. Attempts to restrain demand in 1997 and 1998 were nullified by large slippages in public finances. Flagging market confidence was further weakened by the parliamentary elections, and growing currency pressures made it necessary to float the koruna in October 1998, ending over five years of unchanged fixed parity.

The new government that took office last fall made economic stabilization a top priority. Indeed, the large imbalances, domestic and foreign, are a threat to the gains of the last six years in terms of low inflation, high growth, and a stable currency. The government's economic policies signal a clean break with those of the past. For this year, they aim at bringing the current account deficit down to around 5 percent of GDP. In the first five months of this year, the trade deficit has been declining, and was 20 percent below its level during the same period of 1998. The volume of exports increased by 9 percent in spite of generally weak foreign demand, and exports to EU countries grew by 23 percent. And although domestic demand fell sharply in the first quarter of 1998, imports also continued growing, although only 4 percent.

Reducing the fiscal deficit is the key to reducing the current account deficit. In January 1999 measures were announced to reduce the fiscal deficit by 4 percent of GDP. However, the sharp slowdown in growth which began in the last quarter of 1998 is continuing into 1999, destroying the assumption of 3.0 percent growth on which the fiscal program was based. The staff now expects output growth for 1999 will be 0.7 percent. It is therefore not entirely surprising that during the first five months, fiscal revenues fell significantly short of the target.

Accordingly, on May 31, 1999 the government adopted a corrective package to achieve a fiscal deficit not to exceed 3 percent of GDP for 1999. Besides raising indirect taxes and excise taxes and restoring the import surcharge, the package includes some painful cuts in social spending and will set the stage for a comprehensive reform of the tax and social systems to begin in 2001. In addition there will be some new taxes, on motor vehicles (in late 1999) and on natural monopolies (effective January 1, 2000). Moreover, July 1, 1999 saw the second in a series of steep increases in administered prices. The government is ready to take additional measures if needed to achieve its goals.

In addition to immediate stabilization of the public finances, the government will improve the collection of taxes and social security payments.

Tax evasion and poor payment discipline have become epidemic. By the end of June 1999, arrears in taxes and customs had reached 6 percent of GDP and arrears in social security contributions had reached 7.5 percent of GDP. Several measures and changes in tax laws to strengthen tax enforcement are being approved.

For the year 2000, the general government deficit will be capped at 3 percent of GDP. Although several fiscal initiatives will reduce revenues, the government remains committed to balancing the budget by the end of its term in office. To that end, the reduction of public expenditures will be pursued vigorously. By 2001, the cost of running the government will be brought back to its 1995 level. This will require the elimination of 27,000 government jobs at all levels. A draft plan for decentralizing and reforming of public administration, including a new regional division of the country, has been prepared by the government and will soon be considered. Additional savings will be achieved by reducing the number of extra-budgetary state funds from 12 to 5, reforming health insurance, and adopting a Law on Public Procurement. Finally, launching the Treasury from January 1, 2000 will improve management of the state's liquidity management and reduce the interest costs of financing the budget deficit.

With nominal public sector wages frozen, real wages are expected to decline in 1999, and in fact average real wages in the industrial sector declined by 0.4 percent in the first five months. Retail and banking data reveal that households have been maintaining their consumption level by drawing on savings, but the general living standard will be hit hard by this month's increase in administered prices and by the 70 percent rent increase slated for October 1. The government is therefore giving a high priority to the dialogue with the social partners, and is trying to find ways of protecting the most endangered social groups. This is why it has decided to increase tax deductions for the lowest income brackets, effectively January 1, 2000, and has prepared a draft law on housing allowances that would provide rent support for low-income families. And in order to protect general public support for the reform program, the government is actively pursuing a Stability Pact with the social partners that would ensure social peace for the next 12 months.

Adoption of the fiscal package in May 1999 will give monetary policy a long-awaited respite. The unbalanced policy mix of the last two years was accompanied by high deficits and high interest rates. The fiscal package paves the way for a gradual decrease in the cost of money. But the central bank is cautious not to relax the monetary stance too soon. It will wait until the effects of the fiscal tightening are clearly visible. The recently revised monetary program is therefore more restrained, aiming at private sector credit growth of 3.6 to 6.9 percent for 1999, instead of the original target of 8.7 percent. And while the recent drop in interbank market rates produced by the government's successful eurobond issue is certainly welcome, the monetary authorities are ready to use interest policy aggressively to broadly stabilize the exchange rate and protect international reserves, which is their main external policy objective.

Although the export performance so far this year is encouraging, the government is aware that without a dramatic acceleration in structural reforms, the competitive advantage of the recent currency depreciation will soon erode. In addition, the export boom is limited to only a few industries, like the automotive sector whose exports grew by 40 percent. The government will move decisively to restructure the enterprise sector, as will be required to ensure the durability of the gains in export competitiveness and overall profitability.

As a first step the government will speed up its withdrawal from the productive sector by quickly privatizing those enterprises still in its hands. The Law on Large Privatizations is currently being amended by parliament to ensure the privatization of all but a few strategic enterprises. The government believes that involving strategic foreign investors is the best way of guaranteeing the success of privatization, and will therefore seek a critical role for foreign investment in this process. This is why it is removing all forms of potential discrimination against foreign investors and giving them a level playing field. In most cases, majority stakes will be sold. Where only minority interests are sold, the government will become a passive shareholder by not exercising its management rights. The first of these sales is already under way: an international tender for privatizing Slovak Telecom will be announced in September 1999, and completion is expected in the first quarter of 2000.

Our authorities also realize that greater economic efficiency requires faster removal of non-viable entities from the marketplace. Unlike some past administrations, the new government prefers a decentralized approach to enterprise restructuring. They know that an efficient, and well-functioning bankruptcy process can offer a major way of achieving this goal. Work has already begun on a complete package of all the legislative and institutional changes needed to reform the present framework, including an amendment of the State Enterprise Law which would speed the liquidation of non-viable state enterprises.

More generally, the government believes that a stable, transparent, undistorted business environment, supported by vigorous law enforcement, is crucial for the growth of a sound private sector. In their view, the lack of such a framework is the main reason for the distorted incentives that have often caused the owners or managers of newly privatized companies to behave perversely. Delays in restructuring were bound to aggravate the already precarious position of many enterprises. Even though 80 percent of Slovakia's industrial base has been in private hands since 1996, the financial performance was still deteriorating in 1998, with the entire industrial sector except for the state utilities generating a net loss. Some of the losses may stem from accelerated asset-stripping following the government's announcement that all privatization contracts will be reviewed. But though the authorities realize that in the short term such a review could impair business confidence and scare off foreign investors, they are certain that enforcing the law when it is broken is in the long-term interest of society.

Persistent large losses by enterprises, coupled with a long period of high interest rates, have further aggravated the financial situation of the banking sector. Especially grave is the situation of three large state-owned commercial banks, 45 percent of whose total outstanding loans were nonperforming loans. The government has therefore decided to restructure them and sell them to strategic investors by the end of 2000. This program, designed with aid from international financial institutions including the World Bank and the Fund, has already been approved.

Expectations about the actual cost to the budget vary from Sk33 billion to Sk96 billion, depending on the valuation of existing collateral, but the government puts them at the high end of the range. The rest of the banking system, consisting of medium-sized privately owned banks holding 55 percent of the banking sector's total assets, is generally sound, as shown by banking sector's aggregate capital adequacy of 8.7 percent at the end of 1998. For these banks the government will confine itself to strengthening banking supervision and surveillance, improving reserve and provisioning policies, and increasing the efficiency of bad loan recovery. The necessary legislation will be submitted to the parliament in September 1999.

Speeding up the restructuring of the enterprise and banking sectors will inevitably involve labor shedding, and unemployment is expect to rise from 16.5 percent at the end of May 1999 to as high as 18 percent in September 1999. The government is well aware that its income redistribution schemes cannot address this issue adequately. It is concentrating on creating conditions favoring the development of small- and medium-sized enterprises in order to create new job opportunities. To lower the tax burden on entrepreneurs, it is planned to begin reducing the corporate income tax on January 1, 2000, with a view to lowering it to 25 percent by 2005. And to encourage the replacement of obsolete fixed capital, the budget for 2000 will include an investment tax credit and accelerated depreciation of some fixed capital investments. Preparations are well advanced for introducing, on January 1, 2000, an all-inclusive tax for the self-employed, which would reduce their tax rate and simplify their paperwork burden. The end of August 1999 will see the completion of a review of changes needed to eliminate legislative and administrative obstacles to the development of small- and medium-scale enterprises. And the draft of a law on state support has been submitted to the parliament.

Mr. Spraos submitted the following statement:

A current account deficit of 10 percent of GDP in 1998 and for a third successive year does not brook much argument. Something had to be done. Generally I am in favor of testing the limits to growth. But it is clear that Slovakia had reached the limits of balance of payments-neglecting growth. The current account is the most unforgiving limit—unless your currency is the dollar—and the symptoms that the limit had been reached were clearly there, not least a spread of 4 percent on sovereign bonds, which is very onerous when gross borrowing requirements are large.

When at the same time the fiscal deficit reached 6 percent of GDP, and this within a context of a rapidly growing economy, the fiscal position becomes a prime target for action. Staff and the authorities agreed on this and in the last couple of months, after market pressures underlined the urgency, action has been taken. Decisive, very decisive, action. It is projected that the fiscal deficit will drop to or below 3 percent of GDP, from 6 percent in 1998. But the difference of 3 percent hugely underestimates the turnaround in the fiscal stance. For two reasons. First, growth is expected to drop to less than 1 percent, from more than 4 percent in 1999. (This is staff's projection). Second, the recent measures will operate only for the second half of 1999. So on an annualized basis the reduction in the deficit must be considerably bigger. Thus the negative fiscal impulse is very big.

The obvious question then is: does it amount to overkill? I cannot begin to answer the question sitting around this table. I cannot even make an informed guess about the interproduct or intertemporal substitution effect of the (temporary) import surcharge, which would be needed for gauging the size of the demand shock imposed by the budgetary measures. (There is previous experience in Slovakia with import surcharges. What does it show?). What I think I can say is that it is necessary to be alert to the risk of overkill.

The Czech Republic is a warning in this respect. There are as many differences as similarities between the former twins. Nevertheless, like Slovakia, the Czech Republic had a high (though not quite as unsustainable) current account deficit in 1996 and 1997 that shrunk to only 1.9 percent of GDP in 1998 but, as the economy contracted by more than two percentage points of GDP, staff came to regret that they were late being alerted to the need for fiscal easing. The message of this Czech episode is that the multiplier effects of a demand shock are much larger when there are structural weaknesses.

As the fragility of the banking and corporate sectors is much greater in Slovakia, the need to be watchful and to ease in good time is especially important. The structural weaknesses are part of the furniture for the time being; they are not responsible for the contraction but they can multiply it dangerously. The projected decline of the GDP growth rate from more than 4 percent in 1998 to less than 1 percent in 1999 (year-on-year) very likely implies negative growth territory for the last quarter of 1999 (quarter on corresponding quarter). The change of growth sign is not of practical significance, but zero is a symbolic threshold and if crossed, it should trigger a new in-depth assessment, if one is not done earlier.

What if the reassessment suggests fiscal easing (beyond the timetabled import surcharge reduction) but markets are hostile to it, demanding their full pound of fiscal flesh regardless of any damage to the real economy? What I would do is to preempt the markets by broadcasting (via the PIN) that this is a strong package, appropriate to difficult circumstances, but one which may be legitimately eased if it turns out too restrictive. It would then be on record that the IMF views easing as a valid policy option. This will have an educative effect.

I have one other point that I feel the urge to make, this time related to the composition of the policy package. In addressing the current account problem, the policy burden on the macroeconomic (as distinct from the structural) side is placed almost entirely on fiscal tightening. Yet the initial current account deterioration, which occurred in 1996, was not triggered by fiscal easing. That year the current account deficit rose to 11.1 percent of GDP (from a surplus of 2.3 percent in 1995) but the general government deficit only reached 1.3 percent (from a surplus of 0.2 percent a year earlier). The main fiscal deterioration occurred in subsequent years and compounded the difficulty but was not the initial cause. Chapter IV of the Selected Issues paper is convincing in attributing the ballooning of the current account deficit in 1996 to the deterioration of the saving-investment balance as a result of the big increase in investment, which raised the share of investment in GDP from 28.4 percent in 1995 to 39.4 percent in 1996, where it has stayed in the subsequent three years. Staff draw attention to the possible exaggeration in what is recorded as investment—a phenomenon, incidentally, that is liable to occur in most countries as a result of privileged tax/subsidy treatment of investment expenditure—but do not treat it as important and I have no reason to think otherwise. More emphatically, they argue that investment has been misdirected and low-yielding.

Why then not attempt to squeeze investment expenditure, thus letting it take part of the burden of the attack on excess demand off the shoulders of budgetary tightening? If pressed, I could conjure up a number of policy measures to effect this and effect it on a broad front, since staff does not suggest that inefficient investment is the prerogative of state enterprises only. To some extent the squeeze will happen automatically: unhedged borrowing abroad will be less attractive if the risk premium stays high and borrowing at home will become more expensive if monetary policy is used to defend the currency, as recommended by staff. But as this automatic reaction will occur, if it does, on top of the full fiscal package (not as a partial substitute for it), it may not necessarily be welcome, given the risk of overkill.

Mr. Yakusha made the following statement:

It gives us hope that the new government of the Slovak Republic recognizes that urgent steps are needed to avoid further economic deterioration. I would prefer to look at the economic situation based on de facto developments. In this respect, although new fiscal policy measures have been implemented recently, this chair's assessment of the Slovak economy remains broadly unchanged from last year. The economy is still in bad shape, and is highly vulnerable. The current account deficit remains unsustainable, and the exchange rate has been under downward pressure, thereby exacerbating the situation of the highly indebted enterprise sector. Furthermore, foreign debt has risen substantially, the banking system is weak, and the government could soon face difficulties in financing its deficit and refinancing its debt. The Slovak Republic is clearly faced with serious economic difficulties and policy challenges.

Unfortunately, these difficulties are to a large extent self-generated. An excessively expansionary policy has resulted in large economic imbalances: this year, real GDP growth has decelerated sharply, inflation has accelerated, and international reserves have been depleted further. The question is how the authorities have been able to manage for so long—and, more importantly, what will happen if the recent policy responses prove to be inadequate.

I am in broad agreement with the staff analysis, and will limit my comments to the fiscal and banking sector areas.

With regard to fiscal policy, the rise of the budget deficit from 1 percent to 6 percent in two years is quite dramatic, with half of government borrowing coming from foreign sources and the other half from the domestic sector. The large deficit has placed an additional debt servicing burden on the economy, thereby undermining investor confidence and crowding out private investment. In particular, the 1998 wage increase in the public sector has been substantial, while health and education expenditure has been declining, which means that the composition of overall expenditure remains far from optimal.

Having said that, I welcome indications in the staff report that the authorities have recognized the need to urgently address the situation in order to reverse these trends. The authorities have introduced a package of fiscal adjustment which, if fully implemented, will bring down the deficit to 3 percent. However, as the results of those new measures have not materialized yet, the authorities should also focus on reducing and improving the quality of fiscal expenditure. It is worth noting that even if the current package is implemented in full, the financing of the external current account deficit will still imply a further decline in international reserves.

In the banking sector, the problems are more structural in nature and somewhat alarming. The number of state-owned banks that are insolvent has increased to three—and those same three banks hold 50 percent of total banking sector assets. Furthermore, the volume of nonperforming loans is very large, complicated bankruptcy procedures prevent banks from realizing the real value of collateral, and supervisory capacity remains inadequate. The banks' dependence on the interbank market for liquidity have made them vulnerable to a rise in interest rates, and has prevented the central bank from conducting the tight monetary policy that is needed to correct the macroeconomic imbalances. I agree with the staff that there are systemic imbalances that very likely will lead to the collapse of a number of state-owned banks.

I feel somewhat uncomfortable that we are encouraging the authorities to publish a Public Information Notice. Sections of the staff report might influence the markets negatively. Therefore, I would urge caution, even though I generally remain in favor of publishing a Public Information Notice for the Slovak Republic this year. I would like to end my statement by calling on the authorities to implement thoroughly the staff's recommendations.

Mr. Le Gal made the following statement:

Mr. Spraos summarized very well the problems faced by Slovakia in his preliminary statement. Slovakia has indeed reached the limits of balance of payments neglecting growth. I share the staff's view that the authorities are right to take decisive action in the fiscal area since the external vulnerability must be addressed without delay. Since there is consensus on this objective, I will limit myself to two questions and one comment.

First, external vulnerability entails the risk of financial crisis if the markets feel, right or wrong, that the appropriate corrective policies are not yet put in place. In this regard, I wonder whether a precautionary arrangement could not be part of the answer. The country would have a clear road map for implementing a medium-term program of fiscal consolidation more sustainable than the current import tariff increases or expenditure cuts. This would also allow a regular review of the program and, in case the policy mix might prove to be too tight, some loosening could take place with the IMF's approval to reassure the markets. Maybe the staff would like to comment on this issue.

The other issue is how to decide whether the policy mix is too tight or not. Since there is a medium-term fiscal consolidation need, there should be only moderate room for maneuver on the fiscal side. The dilemma would be to set monetary policy in a way which ensures further disinflation but without excessive cost in terms of growth. The staff considers that foreign exchange seems to be appropriate in terms of competitiveness and that a stable exchange rate would be an important element in meeting inflation targets. Beyond that, could the staff comment on the possibility of also using the real exchange rate as a reference of policy mix appropriateness?

Finally, I would like to reiterate the need to accelerate structural reform. Privatization in Slovakia did not lead to restructuring nor to a well functioning market economy, due in large part to the method of privatization. The question now is how to make them work. In this sense, banking sector restructuring and privatization should be initiated promptly while avoiding the mistakes of the past. An efficient and competitive banking system should help to impose on the corporate sector the much needed financial discipline and hard budgetary constraints.

Mr. Lushin made the following statement:

For our discussion today, the staff has prepared a set of frank and well-focused papers. They present a clear picture of the current economic situation in Slovakia and suggest ways to cope with the sizable economic imbalances. We welcome the fact that the staff and the authorities are in broad agreement in their approach to policy. However, at this stage, the degree of freedom in formulating a proper policy mix is not very large. Therefore, the strong commitment of the authorities to fiscal consolidation and tight monetary policy with the aim of tackling the daunting imbalances is highly commendable, as well as the intention to proceed forcefully with structural reforms.

One should not forget that, in some respects—for example with regard to growth and inflation—the economic performance of Slovakia has paralleled the best in Central Europe, not to mention the CIS countries. The recent successful placement of several eurobond issues also signals that market sentiment toward Slovakia is positive. I therefore believe that the authorities will be able to restore macroeconomic equilibrium and successfully proceed further in the way of transition. As I broadly agree with the thrust of the staff appraisal, I will make just two remarks on fiscal and monetary policy.

It goes without saying that fiscal consolidation should be a pillar of the new policy mix. The authorities' objectives in this area are generally supported by the staff. In this regard, Mr. Spraos speaks about the danger of "overkill" in terms of damage to the real economy. I agree that this point merits serious consideration. However, the risk of "fiscal underkill" can also be substantial, and at this moment it is hardly possible to say what degree of fiscal tightness will be optimal eventually. The authorities should implement the already existing plans, although they and the staff are invited to show some flexibility in case the threat of a serious recession emerges.

Another interesting point mentioned by Mr. Spraos related to finding the right balance between fiscal adjustment and curbing private domestic demand, including, first and foremost, investment expenditure. A chapter in the Selected Issues paper links the external economic imbalances with swelling investment demand. However, not everything concerning this investment phenomenon is clear, and the staff itself admits that "the reasons behind the investment boom are not fully understood." The very fact that the bulk of the nongovernment savings-investment imbalance stems from four public utilities suggests that structural deficiencies lie at the core of this problem. Therefore, promptly addressing structural weaknesses would appear to be more effective for curbing investment demand than macroeconomic measures, such as raising interest rates.

The staff rightly urges the authorities to gear monetary policy toward protecting international reserves while keeping an eye on inflation. To achieve this goal, the staff favors interest rate rather than exchange rate adjustment on the grounds that "the broadly stable exchange rate is an important element to meeting inflation objectives." I wonder to what extent the devaluation of the koruna is inflation-prone and if there could be a case for allowing it to depreciate further by at least avoiding interventions by the National Bank of Slovakia. This idea well feeds the staff's point that the equilibrium level of the exchange rate is uncertain and that the continued float of the koruna should be allowed.

I understand, on the one hand, that the authorities may be unwilling to allow any further depreciation, because it makes the servicing of foreign debt more expensive. But, on the other hand, a weaker koruna, at least until fiscal consolidation takes hold, may be helpful in tackling the current account deficit, and also in shifting some of the adjustment burden from interest rate policy. I would welcome staff comments on this issue. With these remarks, I wish the authorities every success.

The staff representative from the European I Department noted that Slovakia was faced with an unfavorable external environment in which: the prospects for external financing had deteriorated quite sharply. At the same time, a rapid build-up of external debt had to be reversed, and the level of international reserves of the central bank was at an uncomfortably low level.

In those circumstances, one of the main policy recommendations of the staff, which the authorities were in agreement with, was to reduce the external current account deficit to a sustainable level, the staff representative said. The staff recognized that there was a risk of "underkill"—that the fiscal adjustment would prove to be less than targeted or that financing would fall short of projected amounts. At the same time, the staff also recognized the risk of "overkill": when formulating its recommendations on the economic program, the staff had realized that the decline in private consumption could prove a lot stronger than in the staff's projection, if economic agents revised downward their expectation of future income and saved more than anticipated. Investment demand could also prove weaker than projected, though the staff had already assumed about a 10 percent decline in investment. If consumption fell below projected levels, as had happened recently in the Czech Republic, or investment were to be even lower than projected the planned fiscal adjustment could indeed be seen as being overly ambitious, and could run the risk of inducing a decline in domestic demand that would be much stronger than what was called for. In such a scenario, the external adjustment would also be greater than what was necessary over a one-year period.

The staff had originally supported the authorities' target of a fiscal deficit of 2 percent of GDP for the general government during its January 1999 mission, the staff representative continued. In April 1999, it had, however, reassessed the situation, and had recommended instead a fiscal deficit of 3 percent of GDP because domestic demand in 1999 was than expected to be weaker than previously thought. In supporting a larger fiscal decline, staff was criticized by some members of the policy community in Slovakia who thought that the authorities should adhere to the original fiscal deficit target of 2 percent. Nevertheless, the staff took into account the fact that both investment and domestic demand could turn out to be weaker than foreseen in January, and had adjusted its policy advice accordingly.

In May 1999, the authorities introduced a policy package that would deliver the fiscal deficit of 3 percent of GDP, and which would be broadly consistent with the baseline of a current account deficit of about 5 percent of GDP, the staff representative remarked. However, it had to be recognized that upside as well as downside risks remained.

On the one hand, there was a possibility of ending up with a larger current account deficit than projected, if consumer demand were stronger than projected, the staff representative pointed out. Indeed, through the first five months of 1999, real retail sales growth had been exceeding 7 percent, so the slowdown in domestic and consumer demand inherent in the baseline had not yet materialized. It was also possible that net exports would be lower than projected. In addition, enterprises, as a result of higher administered prices than in the baseline, would also receive more funds. If those funds translated into higher wage increases—which the staff did not necessarily expect—that would bode poorly for the targeted external current account adjustment. There were also possibilities for slippages by the general government outside the budgetary sector. As for the state and local government budgets, which the staff assumed would be running broadly in balance, it did not really have enough information at that stage to know what the eventual budgetary outcome would be. For those reasons, risks remained that the external current account deficit would be larger than projected by the staff.

On the other hand, the staff representative noted, the current account deficit could also turn out to be smaller than projected. There were reasons to expect a slowdown in consumer demand as a result of the increase in administered prices and the value-added tax. If the authorities were able to hold the line on wages, enterprise savings might rise. Accordingly, the baseline outlook was currently evenly balanced, and the authorities must pay careful attention to the way the economy evolved and make adjustments along the way.

Ideally, the staff would have preferred to see the fiscal adjustment take place much earlier, the staff representative continued. A switch in the policy mix towards a tighter fiscal policy, would have facilitated a looser monetary policy and a decline in interest rates. And a depreciation of the currency, along with a strong incomes policy, would have generated an improvement in external competitiveness, which in turn would have supported the external adjustment. However, the depreciation of the currency preceded a rebalancing of the policy mix, in part because of financial pressures May 1999 in the face of insufficient adjustment measures. But given the current level of the exchange rate, the staff was of the opinion that external competitiveness was broadly appropriate, and that the targets for the external sector could be met, now that a fiscal adjustment package was in place, the staff would be concerned if the currency depreciated further. Not only would that have adverse consequences on the debt service payments of enterprises, it might also set off a wage-price spiral according to the authorities. The staff had accordingly pointed out to the authorities and the labor unions that a further depreciation might not ultimately generate gains in external competitiveness, and that it thought that the level of the exchange rate was appropriate for the time being. Once it was clear that fiscal policy target of 3 percent could be achieved, monetary policy could be loosened so the policy mix in the end would be readjusted, consistent until the depressed level of the exchange rate.

A precautionary Stand-By Arrangement for Slovakia had been discussed with the authorities, the staff representative noted. Ultimately, however, the decision of whether or not to enter into such an agreement was theirs.

Mr. Spraos noted that the Fund should send a message to the financial markets indicating that the new program of the authorities was sound, and appropriate for meeting the challenges that the Slovak economy was faced with. However, in case the economy reacted more adversely to the new policy measures than expected, the Fund should also signal readiness to allow the program to be relaxed. That would allow the economy to avoid an otherwise inevitable hard landing.

Mr. Donecker made the following statement:

> In view of the excellent staff appraisal and what has been already said by my colleagues, let me just emphasize the following policy issues.

Fiscal policy is indeed the keystone of adjustment; it will have to be one of the driving forces to bring down the current account deficit to a more sustainable level. The authorities announced an ambitious fiscal tightening in January 1999. However, without additional action, the fiscal targets appear at risk. It is encouraging that important steps have recently been taken; nevertheless the legislative process for putting all fiscal measures in place is a matter of great urgency. Slippages outside the budget; i.e., with regard to expenditures of the social security and extra budgetary funds, must be avoided. Budgetary revenue from import surcharges might be welcome in a situation of budgetary problems, however, like staff, we urge the authorities to abolish the import surcharges as soon as possible to avoid any distortionary effects.

We strongly encourage the authorities to gear monetary policy toward price stability. This would also help stabilize the exchange rate. The central bank should not subordinate its actions to concerns over the desirability to lower borrowing costs. If and when necessary, an increase of interest rates should not be delayed. However, appropriate fiscal tightening should help the central bank to meet its objectives. In any case, monetary policy should not be overburdened with objectives beyond the reach of a central bank.

The exchange rate regime should be flexible to allow necessary adjustments under the current difficult circumstances. Given the already low level of international reserves, interventions in the foreign exchange market to defend the exchange rate should be avoided. Changes in macroeconomic policy to establish market confidence; i.e., an appropriate policy mix and a sustainable current account balance, will be essential to avoid erratic fluctuations or a further depreciation of the exchange rate. In our view the depreciated exchange rate will likely contribute to reduce the large current account deficit, while increasing external competitiveness.

Like other speakers, we are very much concerned about structural problems in the banking sector, especially the high level of nonperforming loans. The three state-owned banks are special cases for concern. Since all three institutions are undercapitalized or insolvent, a comprehensive program for their rehabilitation and privatization should have very high priority.

Finally, we have some doubts about the quality of the authorities' statistical estimates for the likely growth performance. In view of the overall rather difficult circumstances it would be prudent to err on the side of caution.

Mr. Kudiwu made the following statement:

I commend the authorities for the progress achieved during the recent years in terms of high growth, low inflation, and stable currency, as clearly stressed in Mr. Kiekens and Mr. Rigasz's informative preliminary statement.

However, the continued vulnerability of the Slovak Republic, as reflected by the unfavorable developments of some major macroeconomic and financial variables, calls for vigorous action to stabilize the economy and accelerate structural reforms.

On fiscal policy, the fiscal target set for 1999 is appropriate, so as to bring to a sustainable level the excessive external current account deficit that the country has experienced. The authorities' intention to curtail domestic demand through cuts in subsidies and purchases of goods and services in nominal terms, and the planned wage freeze for 1999, are steps in the right direction. On the latter, the pursuit of a dialogue with the social partners will remain essential to ensure social peace in 1999 and the coming years. Like Mr. Yakusha, I share the view that there is a need to reduce expenditure, while improving its quality.

In the monetary sector, a tight monetary stance will be needed and I note that this will be helped by the important role that the fiscal package is expected to play in reducing pressure on the monetary policy.

On the structural front, it is important for the authorities to address the weaknesses prevailing in the banking and public enterprises sectors. With respect to the banking sector, the problem of nonperforming loans remains a major concern and should be addressed without further delays. Moreover, the steps being taken to accelerate the rehabilitation and the privatization of the state-owned banks are welcome. The authorities' intention to rehabilitate public enterprises and to improve bankruptcy procedures and corporate governance, as well as the legal and institutional framework, are also issues that need to be addressed.

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

Ms. Brukoff made the following statement:

At last year's Article IV consultation, Directors expressed deep concern about prospects for Slovakia's economic situation given the policies that had been pursued in recent years. This concern turned out to be well placed in light of the adverse developments and external shocks that buffeted the economy later in the year. With sizeable external and internal imbalances posted again in 1998, the risks the Slovak Republic faced (and continues to confront) are home-grown as well as external. These risks heighten both the difficulty and the imperative the new government faces in its effort to put the country firmly on the course of macroeconomic stabilization and structural reform.

That being said, 1999 could prove to be a crossroads year for Slovakia, and we are heartened by the new policy focus and commitment which the new government has adopted. The comprehensive package of fiscal measures and renewed focus on stalled structural reforms approved in May 1999 are the sort of major initiatives necessary to cut the fiscal deficit, begin the process of significant fiscal consolidation, and narrow the current account deficit, which we agree must be a near-term priority in order to bolster market confidence and secure sufficient amounts of external finance to cover outflows. We were less pleased to note the authorities' decision to introduce an import surcharge as a means to address the country's large external imbalance. While the authorities have scheduled the removal of this measure for end-2000, every effort should be made to eliminate it at the first opportunity, if possible before its scheduled phase-out date.

We agree fully with the general thrust of Slovak policies aimed at reducing the twin deficits and making rapid, substantial progress on stabilization, although the way forward looks extremely challenging. A concern in the area of fiscal policy implementation is the extent to which spending by off-budget funds can be controlled in keeping the authorities' intention to cut the general government deficit by 4 percentage points, and cut 5 percentage points off the external deficit. Just last week the Minister of Finance indicated that the fiscal deficit is likely to be 3.5 to 4 percent of GDP this year, not 2 percent as in the original budget, with most of the increase reflecting off-budget fund spending. This inability to restrain deficit spending by the off-budget funds could add almost 2 percentage points to domestic demand, raising the possibility that the forecast for the current account deficit will also be exceeded, and adding to market concerns. Given the prospect that further mid-term corrections may be necessary, we would be interested in hearing staff's views on how the authorities propose to monitor their program, whether specific contingency measures have been discussed in case remedial action is needed, and the extent to which collaboration with the IMF will continue in monitoring program implementation.

Turning to structural reform, we support the authorities' intention to act promptly to reinvigorate and accelerate their efforts in this area to overcome the negative legacy of the prior government's policies. This will be vital, as any delay or lack of measurable progress will suggest to observers that stabilization gains are probably not sustainable and discourage much-needed foreign investment.

In sum, the program outlined by the Slovak authorities is precisely the kind of broad and complex undertaking that is necessary to put the Slovak Republic on a more sustainable macroeconomic path.

Mr. Lehmussaari made the following statement:

The staff paints a very critical picture of economic policies carried out in the Slovak Republic in the pre-election period, and rightly so. After an initial hesitation a new government has, however, shown determination to adopt a significantly firmer policy stance to tackle large external current account and fiscal deficits. It is reassuring to learn from the staff statement that most of the policy measures included in the government's new economic package have indeed now been approved. The pay-off has been immediate. The short-term interbank interest rates have declined 9 percentage points and spreads in Slovakian Eurobonds have declined by 120 basis points to around 300 basis points, the level of which is, of course, still too high.

In general, staff's policy recommendations are on the mark, and there seems to be few disagreements with the authorities on which path to follow out of the currently very vulnerable economic situation. What is important now is the timely implementation of every aspect of the authorities' economic program. The path is very narrow and there is no room for slippages.

In the following I will limit my brief remarks to two points: the first relates to the problematic twin deficit, the second is on monetary policy.

First, the external current account has been in the dark red for some time, but it is not until last year that also the government's budget deficit reached levels to be concerned about. The sustainability analysis in the selected issues paper clearly demonstrate that the authorities do need to intensify their efforts to reduce the current account deficit. What are the options for getting out of this position? As Mr. Spraos points out much of the adjustment burden is placed on fiscal tightening. He also, rightly, raises the question of investment efficiency. Most of the investment activity has not only taken place in a non-tradable sector but part of the investment activity has been driven by distortive incentives. These problems should promptly be addressed by the authorities. Also it is important to keep wage developments in check in order to preserve competitiveness and to help to shift Slovakia's output growth to a more export-led one.

Second, a comment on the monetary policy. I am a bit puzzled over the authorities' monetary policy framework. It seems as if the central bank is trying to reach many objectives when, as I understand it, they are simultaneously aiming at a stable exchange rate, lowering the borrowing costs for the government, targeting a specific inflation rate, and are in addition urged by staff to adopt a policy that safeguards international reserves.

It is, of course, important for the bank to keep a close eye on a wide range of indicators. The objective of monetary policy should, however, be simple and crystal clear. I take it this is a transition period and less complex and more transparent. Monetary policy framework will emerge in the near future.

Mr. Pascual made the following statement:

The economic performance of the Slovak Republic continued to show signs of vulnerability as it had already been doing for the last few years. The year 1998 has, however, brought about signs of exhaustion in economic growth which have definitively worsened the economic outlook for the near future.

External vulnerability has increased considerably since 1996. The excess in internal demand, mainly due, although not exclusively, to an over-expansive fiscal policy has translated into current accounts deficits over 10 percent of GDP during the last three years, increasing the external debt burden and reducing foreign reserves within an internal framework scarcely attractive for external inflows. Structural reforms, in the meantime, have progressed sluggishly, and monetary policy has been basically accommodating and dependent on fiscal needs. The picture is not, therefore, very promising. Urgent measures are needed, and the sooner, the better.

Since I broadly agree with the thrust of the staff's papers, I would like to make just a few comments for emphasis.

Before discussing the main lines of economic policy, I would like to encourage the authorities to reconsider the option of requesting a precautionary agreement with this institution. The current low level of foreign reserves and the high level of short-term liabilities pose a serious risk on the country's ability to undertake much needed adjustment and reforms. In getting a foreign currency buffer they would obtain certain degree of protection against unexpected adverse events, buying some time to address structural problems. Besides, reaching an agreement with this institution would be a favorable message for the markets on the commitment of the authorities to correct past mistakes. In fact, credibility is essential in the short run for the country to finance the huge current account deficit.

On the policy mix, I do not have much to add to the suggestions already made by the staff. It is pretty obvious that fiscal consolidation is a major and urgent need that does not admit delays. I favor a fiscal adjustment mostly based on expenditure cuts. I regret the lack of commitment in not maintaining the wage freeze in the public sector. This is a very bad signal not only for investor confidence but also for its negative demonstration effects in private sector wage settlements. I also agree with a comprehensive review of public administration in general to define as much as possible the role the state must play in the new economic framework. In this sense, stringent enterprises' restructuring and governance and management-enhancing programs are crucial, especially since the four major public utility companies are responsible for a high proportion of national financial needs. Hard financial constraints must rule companies' life.

Monetary policy should focus on price control, adapting monetary aggregate targets to developments in real economy—staff suggestions in this regard favoring a more restrictive stance during 1999 seem wise. The exchange rate must gear to compensate competitiveness losses and accumulate foreign reserves when possible. An asymmetric management is therefore warranted.

Banking sector soundness must be improved immediately. The present situation prevent the banks from promoting savings and reallocating resources from old to new more efficient activities. Recapitalization, improvement of financial supervision, and expeditious privatization are much needed steps that must be coupled with an appropriate amendment of the legal framework to facilitate loan recovery and security in commercial transactions.

In sum, the continuation of past imbalanced policies could bring the country on the verge of external collapse. Remedial actions must therefore be implemented immediately to reduce the high degree of vulnerability the country is showing. The new government has given signs of a more cautious and responsible policy stance that deserves to be commended and supported by this institution. However, much remains to be done and a strong political commitment will be required from the authorities before they can begin to reap the benefits of the difficult reform process that is ahead. My best wishes to the authorities in meeting these challenges.

Mr. Cabezas made the following statement:

We would like to join the staff in welcoming the authorities' commitment to stabilize the economy and make progress on structural reforms, especially in the development of a legal and institutional framework intended to facilitate and promote business relations. As I share the thrust of the staff appraisal, I will be brief and limit my comments to two points.

First, I am somewhat puzzled by the high unemployment rate in the country. Labor market issues have received little attention in this Article IV consultation staff report. Evidence points to the fact that despite years of strong economic growth, unemployment rates have not declined. This suggests that the labor market contains important rigidities that need to be addressed in order to facilitate the overall adjustment of the economy. Staff comments on this issue would be welcome.

Second, I concur with the urgent need to narrow the country's current account deficit. We can only urge the authorities to continue their efforts to implement the required adjustment policy in order to avoid a possible collapse, as the required external financing that is needed to sustain the passive scenario, as set out in the staff report, is at best uncertain.

After several years of high external imbalances, the stock of external debt has increased markedly. What is most worrying is that the level of short-term debt has increased beyond what can be deemed prudent. During 1998, short-term liabilities represented more than 80 percent of gross reserves and more than 130 percent of official reserves. The situation is indeed worrying—and even more so if we note that, with the high level of government guarantees on foreign currency-denominated debt, an eventual further depreciation of the koruna may imply a severe shock to the fiscal accounts. Like the staff, I would call on the authorities to take bold and immediate action to address the economy's external imbalances.

Clearly, the government is the party that must make the biggest adjustment efforts, as it is responsible for 94 percent of the country's current account deficit. In this respect, we welcome the announced fiscal expenditure package, the strengthening of tax collection, and the demanding revenue-enhancing measures proposed for the enterprises sector. A strong and clear commitment to this agenda is crucial in order to send the right message of stability to the financial markets. In this respect, I wonder if the staff could update us on developments related to fiscal policy—an aspect that requires detailed attention is the effectiveness of the control mechanisms that apply to fiscal policy. With these remarks, I wish the authorities luck in their challenging policy endeavors.

Mr. Hagan made the following statement:

I concur with my colleagues in welcoming the shift in Slovak economic policy since the last Article IV consultation. It is right to recognize that a shift has been made, and we hope that the momentum of the last few months can be sustained. I just want to emphasize two points.

First, I agree with Mr. Donecker and Mr. Yakusha on the importance of reform in the banking sector. The scale of negative net worth of insolvent state banks is alarming. Urgent reform is needed, particularly to ensure that adequate financing is made available to viable enterprises and denied to those that are not, and to remove the threat to the fiscal position implied by the weakness of the banking sector.

Second, I agree with the comments in the staff report about the need to improve corporate governance. The staff report points out that weaknesses in corporate governance, combined with the reluctance of state-owned banks to pursue the collection of bad loans, has resulted in a large rise in indebtedness not backed by an increase in productive assets. The absence of effective

> corporate governance is also serving as a key deterrent to foreign direct investment, which is clearly required both to advance the technical capability of the economy and to finance the current account deficit.

The staff representative from the European I Department noted that the authorities had expressed their willingness to further cut back expenditure, should the need arise. That would be done by decree and in an across-the-board manner. There was also another safety margin for meeting the targets for 1999: the staff's calculations indicated that the revenues from the import surcharge could be somewhat higher than what had been estimated by the authorities in the fiscal package. Even though returns from the road tax might turn out to be smaller than estimated, the authorities were otherwise operating according to conservative estimates.

When the staff had first set up the macroeconomic framework for Slovakia, it had not anticipated that the authorities would raise administered prices in sensitive areas to the extent they did, the staff representative said. That was not only helpful with respect to the budget in terms of reduced subsidies and government payments on debt—but also with respect to improving the savings-investment balance of the public enterprises. To the extent that the authorities would be able to maintain control over wages and enterprise expenditures more generally, that provided room for additional external adjustment and represented an upside risk.

The Fund had scheduled a technical assistance mission from the Fiscal Affairs Department in September 1999 in order to follow up on tax administration and improve expenditure control, the staff representative stated. Since the staff only had data above the line through January 1999 for general government nonbudgetary expenditure, it was somewhat difficult to develop an accurate picture for the general government so far this year. It was precisely for that reason that both the staff and the authorities had emphasized the importance of the technical assistance mission in September 1999: the goal was to improve the monitoring and control over expenditure across a broad range of the general government's activities.

In addition, the authorities had invited the staff to return in October 1999 in order to reassess the macroeconomic framework, as well as to provide advice on budgetary preparation for the year 2000, the staff representative added. The close cooperation that had characterized the relationship between the Fund and the new government since October was thus continuing.

With respect to unemployment, the staff noted that it had been pointed out by the authorities on a number of occasions that unemployment benefits were as high as actual wages for certain skill groups, the staff representative said. The authorities had indicated that they were planning to review unemployment benefits, with a view to lowering them. Another relevant issue was the tax wedge, and its effects on both labor demand and labor supply. The planned tax reforms to reduce high payroll contribution and personal income tax would reduce the tax wedge, which would bring down unemployment. While the staff did not anticipate a major turnaround in the unemployment rate in the near term, the measures that were being adopted boded well, in the medium term, for the future growth potential of the economy and for employment.

Mr. Kiekens stated that there was, as indicated by the staff representative, close cooperation between the staff and the authorities. Since the new government had taken office in October 1998, the staff had visited Bratislava three times, while the authorities had visited Washington twice in the meantime. Those five high level meetings had yielded an excellent analysis of the economy, as well as sound policy advice. He particularly welcomed the appendices in the Selected Issues paper dealing with privatization, governance, and the performance of the enterprise sector and its effect on macroeconomic policies.

One Director had concluded that the government's program would be successful in putting the Slovak economy on a sustainable path, Mr. Kiekens noted. Other Directors had expressed concern that there was a risk of "overkill," should fiscal policies prove to be too tight. He agreed with the staff representative that the policy mix at the present juncture was far from ideal, as the fiscal tightening had come too late.

Mr. Le Gal, Mr. Lushin, and certainly Mr. Spraos had recommended that the Fund continue its dialogue with the authorities and monitor the situation closely so as to stand ready to recommend fiscal relaxation if warranted, Mr. Kiekens continued. While he agreed that close monitoring was necessary, the risk of fiscal relaxation was presently the greater threat: most governments had ambitious targets, but far from all were able to meet them. In that respect, it had already been mentioned that the Minister of Finance now believed that the fiscal deficit would be 3.5 or 4 percent, rather than the targeted 3 percent.

He was in favor of a precautionary Stand-By Agreement for Slovakia, but the decision belonged to the government, Mr. Kiekens concluded. The external policy advice that was being provided not only from the Fund, but also from the OECD and the EU, was instrumental in keeping the ambitious economic program of the government on track. Slovakia was eager to join the OECD and even more eager join the EU. The prospect of becoming a first track candidate for EU accession, which Slovakia was not at present, was a powerful incentive to implement the right macroeconomic policies and restructure the corporate and banking sectors.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted the severe difficulties that the Slovak economy had faced in recent years. The external current account and fiscal deficits were large, and strains in the banking and enterprise sectors had become increasingly visible. These developments had put the Slovak Republic's achievements since independence at risk—including its good growth and low inflation record. Directors stressed that the key priority for macroeconomic policy in 1999 was to reduce the external current account deficit to a sustainable level, and that tighter fiscal policy would have to be the driving force behind the external adjustment.

Directors therefore commended the authorities' decision to substantially reduce the deficit of the general government to about 3 percent of GDP in 1999. They welcomed their announcement of a strong and courageous fiscal package in May, and looked forward to parliamentary approval of the few elements of the package that had not so far been adopted. However, Directors expressed regret over the imposition of the import surcharge, and urged that it be phased out quickly. A few Directors noted the possibility that a further significant weakening of the economy could complicate the achievement of the deficit reduction target in the second half of the year, in which case a reassessment of the policy stance could be called for. Directors encouraged the authorities to continue their close policy dialogue with the Fund.

Looking to next year, Directors observed that the setting of fiscal policy would need to take account of trends in the real economy and in the external accounts. However, they stressed the importance of attacking structural weaknesses in the budget, notably the high level of government spending and the tax burden relative to GDP, as well as the need to improve the quality of expenditure. Directors welcomed the authorities' plans to cut employment in the budgetary sector and implement further measures to rationalize the system of social benefits and pensions. In addition, they encouraged the authorities to strengthen their control over the operations of the general government outside the state budget.

Directors generally considered that, following the floating of the koruna in late 1998, monetary policy should be geared to protecting the country's international reserves and containing underlying inflation. They observed that international reserves were at an uncomfortably low level, and that a broadly stable exchange rate was important for achieving inflation objectives. They therefore considered that the National Bank of Slovakia (NBS) had to be prepared to raise interest rates in case of balance of payments pressures, and that monetary policy decisions should not be subordinated to concerns about government borrowing costs. However, a few Directors considered that some further depreciation of the currency could be helpful, although others noted that depreciation would unfavorably affect the cost of servicing foreign debt. Directors saw fiscal tightening as essential to help the NBS meet its objectives and to set the stage for a sustainable reduction in interest rates. Indeed, recent fiscal actions already appeared to have helped steady financial markets. Several Directors noted that the high level of investment by state enterprises may have been excessive. They considered that structural reforms to improve financial discipline could help address this problem and facilitate demand management.

Directors emphasized the importance of wage restraint in easing the burden on financial policies, and especially in maintaining external competitiveness. Some Directors also noted that it was unfortunate that the authorities were unable to extend the wage freeze from the budgetary sector to the state enterprise sector as originally intended.

Directors expressed concern over the rapid increase in nonperforming loans of the state-owned banks and over the fragile situation in the banking sector generally. They stressed that rapid implementation of a comprehensive bank restructuring program, including strong measures to cut banks' operating costs and reinforce their credit policies and loan recovery efforts, should be given high priority. In this context, they emphasized that the authorities should aim to privatize the state-owned banks, with the involvement of strategic investors. Directors welcomed the authorities' intention to cooperate closely with the World Bank on these issues.

Regarding the state-owned enterprises, Directors observed that weak financial performance, unwarranted wage increases, and recent difficulties in servicing debt were indications of weak governance. This problem should be addressed both in its own right and as a necessary complement to improving banking sector performance. Directors considered that strengthening creditor rights and improving bankruptcy procedures would help promote enterprise restructuring. They urged the authorities to accelerate and complete enterprise privatization, and, in the meantime, to strengthen enterprise financial discipline.

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

2. CZECH REPUBLIC—1999 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1999 Article IV consultation with the Czech Republic (SM/99/150, 6/28/99). They also had before them a statistical appendix (SM/99/157, Rev. 1, 7/15/99; and Sup. 1, 7/7/99).

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

This statement describes key economic and policy developments since the staff report (SM/99/150) was prepared. The staff appraisal in the report remains valid.

On monetary policy, the Czech National Bank (CNB) lowered its key 2-week repo rate by a further 40 basis points to 6.5 percent on June 24. This reflected the continued absence of significant inflationary pressures and renewed upward pressures on the exchange rate, with the koruna having appreciated to CZK 36.8 per euro from a low of about CZK 38.5 per euro at the end of March. The currency has remained broadly stable since then. The strengthening of the koruna in recent months has been attributed in part to a sizeable inflow of foreign direct investment associated with the sale of one of the state-controlled banks (CSOB), but may also have been influenced by the government's reported plans to borrow up to e 2 billion in the international capital market. The adjustment of monetary policy was consistent with the staff's recommendations.

On fiscal policy, the state budget deficit was limited to CZK 6 billion (about 0.3 percent of annual GDP) in the first half of 1999 compared with the revised forecast in April of a deficit of 22 percent of GDP for 1999 as a whole. This reflected both a better than expected performance of revenues and curtailment of expenditures. While the deficit is typically larger in the second half of the year, it appears that automatic fiscal stabilizers are not being allowed to operate fully. At the same time, the staff's concerns about fiscal prospects for 2000 and beyond remain: little progress has been made with regard to preparing the budget for next year, and new tax measures proposed by the government and consistent with the staff's recommendations were recently rejected by Parliament.

On bank and enterprise restructuring, a contract for the sale of the state's 66 percent share in CSOB to the Belgian KBC bank for US$1.1 billion was signed on June 24. Progress with implementing the industrial revitalization plan has been slow, although a tender was announced for the management of the Revitalization Agency (with a deadline July 23). A list of 39 industrial enterprises eligible for consideration in the program has been prepared.

Recently released data are broadly consistent with staff projections, although output data were slightly worse than expected.

Real GDP in the first quarter of 1999 contracted by 4.5 percent (year-on-year) reflecting a sharp decline in fixed investment as well as a negative contribution from net exports, while both private and government consumption were higher. There were some signs of improvement in manufacturing, and industry data for the second quarter of 1999 suggest that the downturn may be bottoming out. The national accounts have been rebased to 1995 prices and revised accordingly—the revised data, which were published after the preparation of the staff report but included in the Statistical Appendix (SM/99/157)—show a slightly more gradual and less severe downturn in the economy.

Net inflation amounted to -2 percent (year-on-year) in June, while CPI inflation stood at 23 percent. Nominal wage growth in industry was about 6 percent in the first five months of 1999, while real wages grew by about 3 percent.

The trade deficit declined to CZK 22 billion in the first five months of the year (compared to CZK 34 billion in the same period of 1998). Imports were down 22 percent and exports were up by 2 percent in value terms, and there was a further improvement in the terms of trade of about 2 percent.

On other issues, the Czech Republic is participating in the preparation of an experimental Transparency Report, which is scheduled for Board discussion in early September, 1999.

Mr. Kiekens submitted the following statement:

Recent Developments

For the Czech economy, 1998 was marked in red. Already in 1997, growth decelerated sharply due to devastating floods, financial market turbulence, and the subsequent tightening of monetary and fiscal policies. In 1998, the economy continued to weaken, with real GDP ending the year at 2.3 percent below 1997. In the first quarter of 1999, real GDP was 4.5 percent lower than for the first quarter of 1998.

The most recent data confirm that the weakness of the economy is continuing and suggest that the prospect of recovery is at best tentative. Most private sector observers foresee a slight decline in real GDP in 1999, with some revival of growth in the fourth quarter. The latest quarterly forecast of the Czech Statistical Office expects real GDP to decline in 1999 by 0.7 percent. The staff expects, probably correctly, that the recovery will be slow, and at least initially not very strong. The latest data for June show industrial output continuing to decline, by 2 percent (equivalent to 6 percent if adjusted for the number of working days) and a rapid decline in construction (about 10 percent). Also, after momentarily declining, the unemployment rate has climbed back to 8.5 percent. On the positive side, in May exports increased by 15 percent in terms of current prices, while import growth was 4 percent. In March, retail sales jumped by 9.3 percent in real terms, and continued to increase moderately in April and May. Together with the modest real growth in private consumption in the first quarter, these data suggest that the moderate growth of real wages has begun to encourage household spending. But investment demand remains very low.

The continuation of weak economic activity, low prices of commodities (except for oil), and some unexpected strengthening of the koruna have combined to keep inflation very low. In the 12 months ending in June 1999, consumer prices increased by 2.2 percent, and net inflation for the same period was negative at -0.6 percent. In the absence of government, price deregulation, headline inflation will likely decline further in July and August, before increasing somewhat later this year. Net inflation is likely to come in under the CNB target of 4–5 percent for the end of 1999.

In June, the authorities successfully completed the sale of a 66 percent share in the third largest commercial bank, the CSOB, for Kc40 billion (about $1.1 billion). The sale of this bank noticeably affected the foreign exchange market: strong demand for the koruna caused the currency to appreciate, although later there was a partial reversal of this appreciation. The expected sales of the state's remaining ownership shares in other commercial banks and nonfinancial companies, involving strong inflows of FDI, could generate similar appreciation pressures. Indeed, the CNB believes that FDI inflows in 1999 and 2000 could be even higher than projected by the staff. But even though large inflows of FDI could generate further upward pressure on the koruna, over time they should also lead to an improvement in export performance.

Strategy for Supporting the Recovery

The Czech economy's poor growth performance since 1997 contrasts sharply with rapid growth in other transition countries in the region, and raises important questions about the reasons for it. Did the sharp economic slowdown occur because the monetary policies pursued following the currency crisis were too tight? Or did it result from inadequate progress in restructuring the corporate sector and weaknesses in the banking sector? The answers to these questions will be important for designing the policy strategy aimed at restarting economic growth.

Our authorities agree with the staff that the poor growth performance of the Czech economy results mainly from structural weaknesses in the banking and corporate sectors and from unsatisfactory progress in completing institutional reforms and installing a well functioning, market-oriented legal framework. Tight financial policies, especially in late 1997 and 1998, were doubtless an aggravating factor. But the sharp weakening of economic activity was really produced by the combination of a highly monetized economy (with a heavily indebted enterprise sector), a badly designed and poorly implemented bankruptcy law, and the tightening of monetary and fiscal policies in response to growing external imbalances and mounting inflationary pressures. Because the recession stems from multiple, mutually-reinforcing causes, an effective strategy for reviving the economy will have to consist of mutually-supportive macroeconomic measures and structural reforms.

Monetary Policy

In December 1997, after conducting monetary policy for several months without any formal framework, the Czech National Bank (CNB) began to implement inflation targeting. At the time, inflation was high and rising, and the external situation was extremely uncertain. These conditions, together with the necessity of fostering the credibility of the inflation targeting framework, persuaded the CNB to pursue a tight monetary policy. During its discussion of the Czech Republic's Article IV consultation in February 1998, this Board also recommended a tight stance of monetary policy.

Later on during 1998, inflation began to fall rapidly, largely because of falling commodity prices, but also because of the rapid weakening of domestic economic activity. At the outset, the CNB could not be sure how long this new trend would last, and responded only by small interest rate cuts. But as it became obvious later in the year that both headline and net inflation were falling rapidly, the CNB began to reduce interest rates more aggressively. Between August and December 1998, it cut its repo rate from 14.0 to 9.5 percent. In 1999, the continued weakening of economic activity, the relatively strong koruna, and continuously declining inflation made it possible to cut the repo rate further, to 6.5 percent by the end of May. In addition, the CNB has decided to reduce the minimum required reserves from 5 to 2 percent.

Up to now, however, because the two traditional channels through which monetary policy affects economic activity have not worked very well, these measures have been rather ineffectual for stimulating economic activity. First, although the interest rate cuts have narrowed the interest differential between the koruna and major currencies, they have not weakened the koruna as much as the authorities wanted, partly due to the already mentioned strong FDI inflows during 1999. Second, lower interest rates and briskly growing bank deposits have not resulted in a resumption of lending to enterprises. Though broad money has grown by almost 10 percent from May 1998 to May 1999, koruna credits to enterprises decreased by about 8 percent during the same period. The banks prefer assets that are safer than loans: the quantity of CNB bills held by commercial banks jumped from Kc110 billion in May 1998 to Kc206 billion in May 1999.

To summarize, the adverse effects on economic activity of the monetary tightening following the currency crisis of mid-1997 have not been matched by beneficial effects produced by the subsequent easing. The CNB intends to retain an easy monetary policy, and will explore whether there is room for further interest rate cuts. But with interest rates already very low, and abundant liquidity in the banking sector, further significant cuts in interest rates would probably have only marginal effects on economic activity but would heighten the risk of instability in the foreign exchange market.

Fiscal Policy

The Czech Republic has a tradition of prudent fiscal policy, epitomized by its rule of balanced state budgets. In 1995 and 1996, when capital inflows were strong, the economy overheating, and the current account deteriorating, there were calls for tightening fiscal policy still further. Later, during 1997, the government did tighten fiscal policy and maintained its tight fiscal stance in 1998 as well. Once more, with the benefit of hindsight one might argue that fiscal policy should have been eased in 1998 to allow the automatic stabilizers to operate. But it must be kept in mind that fiscal policy is more unwieldy and less flexible than monetary policy. Moreover, the tradition of balanced budgets (though not always balanced outcomes), and widespread doubts in the Czech Republic about the usefulness of active fiscal policy for stimulating economic activity, did not make the authorities eager to implement a deliberate fiscal stimulus.

In the end, however, the severity of the economic downturn in 1998 has forced the authorities to abandon, for the first time, their rule of presenting a balanced state budget. Parliament has approved a state budget for 1999 with a deficit amounting to 2 percent of GDP. Since then, the continual weakening of this year's projected growth indicates that the actual deficit will probably be even higher. The authorities agree with the staff that automatic stabilizers should be allowed to work, and that it is not practicable to try to hold deficit close to its original target. They also recognize that the medium-term structural weaknesses in the state budget must be addressed as soon as possible. The staff has done a commendable job of presenting the authorities with medium-term fiscal scenarios which give some indication of how large a fiscal adjustment will be needed and will help focus people's minds on this issue. These scenarios have been made available to the public and should help muster the political support for making unpopular but necessary steps.

Structural Reforms

In view of the limited ability of monetary policy to stimulate economic activity, and of the need to address the weaknesses in the fiscal area soon, the task of stimulating economic growth under the authorities' strategy belongs mainly to structural reforms. This year's staff report is openly critical of the Czech Republic's progress with structural reforms. This openness is well taken by our authorities. The structural agenda ahead is difficult and demanding, but the authorities are determined to move ahead as fast as they can.

One critical weakness of Czech economic reforms till now has to do with corporate governance and the role of the banks. For years, lax bank lending policies have helped keep a large part of the corporate sector on a relatively soft budget constraint that did not press corporations hard enough to adjust their production and costs to new market realities. Excessive wage growth, growing external imbalances, and a growing stock of bad loans were the result. In 1997, the authorities realized that radical change was needed, and began the process of bank privatization. They sold two medium-sized banks in 1998 and the third largest bank in 1999, and are determined to finish, as soon as possible, the sale of two remaining banks, though this could prove a longer, more difficult process due to their size and shares of bad loans. The authorities are also determined to significantly reduce the state's holdings in the nonfinancial sector. It is expected that when privatization is complete and strategic foreign investors are in charge of domestic banks, the pressure to improve corporate governance will increase significantly. This pressure, combined with the weakness of the labor market, should allay the staff's concern that rapidly rising wages might undermine prospects of an export- and investment-led renewal of growth.

The authorities are taking many other steps besides privatization to improve the institutional and legal framework. The Bankruptcy Act is presently being revised to strengthen the rights of creditors. In addition, the notion of out-of-court settlements, and the so-called London Approach to restructuring indebted corporations, are being discussed. A Restructuring Agency was established in April aimed at helping with the financial restructuring and subsequent privatization of overindebted but otherwise viable large industrial companies. It is clear that none of these measures can quickly produce tangible benefits in terms of stronger economic activity, but implementing them resolutely is the only way of returning the Czech economy to the path of strong economic growth.

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

The Czech experience does not differ much in form from the crisis countries in Asia where we have witnessed the overkill of fiscal and monetary tightening that has led to a severe economic recession. The magnitude of the severity is, nonetheless, less than many other crisis-stricken economies. External stability has been achieved at the cost of depressed domestic demand and high unemployment. Now growth has to be jump-started again through the easing of both fiscal and monetary policies, which had been kept too tight for too long. At the same time, inflationary pressure must be closely monitored as interest rates are falling and the exchange rate is expected to weaken further in support of exports, while oil prices and administered prices are on an upward trend. The situation remains fragile and recovery will not be sustainable without a faster and more effective restructuring of banks and public enterprises.

The 1.5 percent growth of GDP assumed in the 1999 budget seems to be on the high side, while the staff forecasts no growth and the markets expect a continued slight contraction. Would a larger fiscal deficit be warranted, in view of the limited impact of lower interest rates on boosting private investment in the environment where bank lending has yet to return to normalcy, and given the low level of public debt? Nevertheless, the higher deficit should be spent most productively on high priority investment projects, if the fiscal stimulus were to produce effective results in terms of economic growth as intended. Capital expenditure, 11 percent of total government expenditure, is relatively low by any standards, while subsidies and transfers account for two-thirds of the total. We are of the opinion that the sector that needs to be cushioned most from the impact of the recession is not the enterprise sector but society. In this regard, loss-making enterprises should not be shouldered by the government indefinitely. With the targeted accession to the EU by 2003, it is all the more urgent to map out a clear, reasonable, and workable strategy to achieve medium-term fiscal sustainability. Chapter IV of the background paper provides a very helpful analysis, and points to the need for extensive fiscal and other structural reforms in order to meet the many challenges and uncertainties ahead.

We share the staff's concern over the excessive increase in government wages which sent a wrong signal to the market, creating inflationary expectation and making it more difficult for the wage rates in the economy to adjust to the downward inflationary trend. Under the prevailing economic circumstances which are still far from full recovery, and the low profitability of enterprises, the real wage increase of 2–3 percent seems indeed unjustifiable unless accompanied by increased productivity. A wage freeze, if not cut, would help improve the competitive edge of the export sector and help facilitate non-inflationary recovery of the economy.

One of the encouraging signs was the reflow of foreign direct investment in 1998 comparable to the level experienced in 1995, as well as its brighter prospect ahead that points to the return of investor confidence. With privatization expected to pick up pace, the external account seems to be comfortably healthy, and poses no threat to macroeconomic stability in the short run.

In the banking sector, staff pinpoints the tightening of monetary policy and prudential rules, from mid-1997 through 1998, as well as the legal and regulatory framework as the main causes of the deterioration in banks' financial positions and the resultant credit crunch. Does this suggest another failure of our policy advice when at the last Article IV Consultation we commended the authorities for their success in the stabilization effort "without imposing undue burdens on the banking and enterprise sectors," and endorsed the adoption of inflation targeting? We seemed to underestimate the effects of prolonged and excessively tight financial policies, and the vicious circle of economic recession, poor performance of corporations, high level of nonperforming loans coupled with strengthened prudential regulations, and a handicapped financial sector.

Despite the gradual lowering of the minimum reserve requirement and excess liquidity in the system, banks remain reluctant to lend the additional available resources. As noted in Mr. Kiekens' and Mr. Jonáš' helpful preliminary statement, further cuts in interest rates by the central bank tend to produce only marginal effects on economic activity. This is due to the high NPL ratio, which is more pronounced in the case of state banks. Against this background, we see an urgent need for the authorities to speed up more vigorously bank privatization and to involve more actively in the restructuring of both the banking sector and massive enterprise debts. The announced Industrial Revitalization Program is a promising step in this direction, and the government is urged to carry it out expeditiously. Nevertheless, as staff noted, this should be accompanied by an improvement to the legal framework for a more efficient bankruptcy and foreclosure process, including an establishment of bankruptcy courts.

Finally, we would like to commend the Czech authorities for their success in restoring stability to the economy with strong macroeconomic policy adjustments. The difficult task now is to steer the economy out of recession on a sustainable long-term growth. We wish the authorities success in meeting these challenges with a view to progressing towards the planned accession to the EU.

Mr. Spraos submitted the following statement:

The Czech economy has had a tough time in recent years and there is much that can be said at both the structural level and at the macroeconomic level. But I will be very selective.

I begin by agreeing with staff and the authorities that structural reform is essential but add that, with accession to the EU as the spur, I am confident that structural reform will be implemented and on a much wider front than encompassed by IMF surveillance. Not all EU structures are admirable but the balance is, I believe, very positive. As EU accession is the dominant national project in all the candidate countries, the conditions that need to be satisfied will be satisfied. No ownership problems here. The target date for accession is ambitious and there are loud grumbles about slow progress. So there may be slippage, but the basic commitment is, as I understand it, rock firm.

Where IMF suggestions overlap, complement, or are adjacent to EU requirements, how far does or should the IMF's position take into account the EU project? Let me raise privatization in this context.

Privatization is not generally an EU requirement. But the opening up of competition generally is. Does this make a difference? Competition, not ownership, is the most critical factor in increasing efficiency, at least in industrial countries. And the opening up of competition will come through the EU together with a hardening of the budget constraint. Should this make the IMF a little more relaxed on privatization as the EU accession process matures?

The Revitalization Agency seems a clever way of coping with enterprises with inherited difficulties. But it is not clear to me what will happen to enterprises not eligible for selection under the program or eligible but not selected. I would welcome information on this. In general, I agree that unviable enterprises should close down (subject to a few well-defined and reasoned exceptions and to sensible pacing for the rest). As subsidization of enterprises is not, in general, permitted in the EU, this is bound to happen anyway. In the meantime, however, viability should not be judged under the adverse conditions of a severe recession but over a cycle. This is an important distinction that, by now, should be uncontroversial. It is worth making explicitly.

Turning to macroeconomy, let me first take a backward look at 1998. It was a very bad year. GDP contracted by well over 2 percent. While attributing the contraction mostly to inadequate structural reform effort, the Staff Report acknowledges that staff "had been slow in recognizing the need to ease macroeconomic policies." I welcome this and look forward to other candid but also more analytical assessments of past advice.

Occasional errors are human but detection of bias requires analysis both across cases and case-by-case. In the particular instance under consideration, it has to be said that there were two factors that pointed to fiscal tightening as a relevant option in the policy agenda: a big current account deficit and a recent adverse market episode. It was, however, not the right option to choose and I am glad to say that the record shows that at last year's Board discussion a number of Directors gently questioned the fiscal emphasis, though this is not evident in the summing up.

Looking now to the period ahead, staff found themselves in the unusual position of trying to talk the authorities into a less conservative fiscal behavior in 1999 than they were prepared to contemplate at the time of the consultations. It is not obvious to me how big the differences were. Was it just a difference between full and partial play of automatic stabilizers? Or was discretionary expansion at issue as well? I get the impression from Mr. Kiekens and Mr. Jonáš that the authorities have moved closer to the staff position. We now know that GDP in the first quarter of 1999 contracted in a big way—by 4.5 percent year-on-year—which lends support to the more fiscally expansionary viewpoint but also raises the question of whether more needs to be done.

Wages were given much attention in last year's Staff Report and in the Board discussion. They are addressed again in the current Report, though somewhat less prominently. We are told that the authorities, including the central bank, "engaged in discussions with social partners." This I believe is new in the Czech Republic. Then comes the very interesting statement that "while the unions had accepted the need for no real wage increases they had not been convinced of the low inflation prospects for 1999 and no agreement on incomes policy has been reached" (para. 20). There must be a complex reality behind this proposition that cannot be comprehended at this distance and without much more information. But the impasse, as described, has a well-known way out of it: a wage agreement with a catch-up clause. Such a clause, by providing for compensation if actual inflation exceeds projected inflation, eases the unions' distrust of inflation forecasts. Staff urge consideration of such an arrangement in paragraph 44. I welcome this warmly and hope that we shall see a more generalized acceptance of its value in the Fund. In certain circumstances the commitment to compensate can be an embarrassment, but it has worked well elsewhere and it is especially suitable in the circumstances described.

In the event, the projection for the rate of the real wage increase in industry in 1999 is 4 percent (Table 1). This is rather different from zero and clearly a suboptimal solution, since all parties were said to have accepted that something close to zero was needed. I can think of two major unintended results of this. One is a worsening of competitiveness, though this has to be seen in conjunction with the exchange rate. The other is the boosting of private consumption. In present circumstances the latter is not unwelcome. But for this, a more expansionist policy stance would have been required.

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

The severe economic downturn in the Czech Republic in 1998 was unfortunate. While tight financial policies succeeded in reversing the serious macroeconomic imbalances that emerged in 1997, the cost to the real economy was excessively high. Thus, as the current account deficit and inflation declined, real GDP contracted sharply and unemployment rose significantly. In their well-written report, the staff make a distinction between the immediate cause of the severe recession, namely the prolonged tightening of fiscal and monetary policies, and the root of the problem which lies in the persistence of serious structural deficiencies in the state-controlled banking sector and the enterprise sector. While the distinction is valid, one could argue that it was to be expected that the prolongation of tight policies and the structural deficiencies in the economy, which were well known and which could only be resolved in a longer time frame, would reinforce each other, thereby bringing about a severe contraction in activity. The authorities' cautious approach to easing the policy stance, even as the evidence of a sharp contraction in activity mounted, was understandably influenced by the domestic political uncertainties that prevailed for practically all of 1998 and also by the fear of spillover effects related to the eruption of the Russian crisis. While staff was refreshingly candid in admitting that it also had been slow to recognize the need to ease macroeconomic policies, it would have been useful to provide more elaboration on the reasoning behind the staff's earlier position. It would also have been helpful, though by no means easy, to attempt to determine the cost in terms of lost output attributable to the delay in policy easing on the economy. Granted that progress in addressing structural problems was clearly inadequate, the question still remains to what extent the severity of the downturn would have been mitigated had policies been eased sooner, and what were the factors that led to the staff's tardy recognition of the need to ease macroeconomic policies. Such analysis may provide some useful lessons for Fund surveillance more generally.

Turning to the outlook for the remainder of 1999, we would agree that while the recent relaxation of policies should help the economy turn around in the course of the year, the recovery will be slow. The deteriorating employment situation is likely to keep consumer demand subdued, while the credit crunch affecting the financially distressed enterprise sector would be expected to continue to restrain credit and investment growth in the coming months. Furthermore, given the slower than earlier anticipated recovery in Europe, foreign demand from European export markets is unlikely to pick up significantly before the last quarter of 1999. The Czech authorities will, therefore, need to continue to maintain a macroeconomic policy stance aimed at boosting domestic demand. However, it will be important for the policy mix to preserve the gains that have been achieved on the inflation front over the past year. To this end, it will be essential to achieve a faster deceleration of nominal wages in the enterprise sector, particularly since excessive wage growth has been at the root of past inflationary pressures. Unfortunately, the signal given by the large increase in wages in the government sector and the railways in the 1999 budget was not helpful in that regard. A firm link between future wage increases and expected inflation must be established. We would appreciate staff views on the likely prospects for meaningful wage restraint in the coming year.

While we had sensed from the staff report that there was a slight difference of views between staff and the authorities on the extent of fiscal and monetary easing that would be appropriate at this stage, the recent reduction in the key 2-week repo rate by the central bank, indicates an increased convergence of views, at least with regard to monetary policy. We are in agreement that upward pressures on the exchange rate arising from substantial foreign direct investment inflows in connection with the planned privatization of banks and utility companies should be resisted to the extent possible. Even though competitiveness does not appear to be a problem at present, it will be important to assure the maintenance of a competitive exchange rate in support of a recovery of exports and growth. In this connection, we note staff's assertion, in footnote 11, that the presently weak transmission of monetary policy due to the virtual breakdown of the credit channel to a large part of the enterprise sector provided some additional room for a decline in interest rates. Messrs. Kiekens and Jonáš, in their helpful statement, also refer to the apparent lack of effectiveness of monetary policy easing in stimulating economic activity. Does the staff think that, following this latest monetary easing in June, the scope for further interest rate reductions at this stage has now been fully utilized?

On fiscal policy, the staff is calling for a full operation of fiscal stabilizers while the authorities remain somewhat more cautious, noting in particular, the difficulty of reversing a significant increase in the fiscal deficit. Given the apparent absence of inflationary pressures at this juncture, and provided meaningful progress is made on the wage front, we are inclined to favor the staff's views. This is further reinforced by the relative ineffectiveness of monetary policy due to the banks' reluctance to lend to the distressed enterprise sector. Nevertheless, we share the authorities concerns on the future course of fiscal policy, particularly since the structural weaknesses in the budget make the medium-term fiscal outlook worrisome. These concerns should, however, be addressed through the adoption of a medium-term fiscal consolidation plan, that would include a start to the process of restructuring the public finances in the 2000 budget.

As noted above, the medium-term fiscal outlook is cause for concern. The staff papers point to a number of structural weaknesses in the budget, most notably a high proportion of mandatory expenditures and the low buoyancy of the tax system. Under current policies, and optimistic assumptions, a fiscal deficit of about 4 percent of GDP is projected over the medium term. When account is taken of additional EU related expenditures and the costs associated with contingent liabilities and bank and enterprise restructuring costs, the deficit projections would be much higher. This calls for early action on formulating a medium-term fiscal strategy that would contain the deficit at a sustainable level, while promoting high growth. Such a strategy should include a broadening of the tax base, a containment of subsidies and transfers and a reform of the pension system.

Finally, we would like to underscore the crucial importance of an acceleration of structural reforms for the achievement of a strong and sustainable economic recovery. Foremost among such reforms is bank and enterprise restructuring and privatization, as well as the reform of the legal and institutional framework. Unless the weaknesses in these areas are addressed forthrightly, the impressive gains achieved since the start of the Czech transition to a market economy could slip away. We are, therefore, pleased that the authorities have accelerated the bank privatization process, and welcome the recent completion of the privatization of the CSOB. We are hopeful that the ambitious plan to privatize the remaining two state-controlled banks by early 2000 will proceed as scheduled, and that the regulatory and supervisory framework for the financial sector will be strengthened further. We also welcome the recent approval of the industrial revitalization plan aimed at addressing the problem of excessive indebtedness faced by many of the enterprises privatized through the voucher system. To help assure the success of the program, however, like staff, we would underscore the importance of assuring the lack of political interference in the operation of the Revitalization Agency which should operate as a truly private equity fund. We also emphasize the importance of providing the management of the fund with adequate incentives to pursue a rapid and efficient divestment process.

We wish the authorities success in meeting the difficult challenges that lie ahead.

Mr. Morí submitted the following statement:

An assessment of the Czech Republic's economic performance is useful after two years from the currency crisis in May 1997. The Czech Republic was seriously hit in 1997 by the second wave of financial crisis affecting emerging market countries in the 1990s, perhaps even before the crisis in Asia actually took place though some turbulence was already observed. Compared to the severity of the crisis in Asian countries, the effect of the so-called "boom-bust swings" in international capital flows has been more gradual in the Czech Republic, but not necessarily less costly in terms of welfare loss.

After reaching an exceptionally high GDP growth rate of 6.4 percent in 1995, the economy decelerated to 1 percent in 1997, and contracted further to a negative growth rate of 2.7 percent in 1998. In Figure 1, we can see this decelerating trend evolving already since the fourth quarter of 1995 and, as mentioned in the staff's update, continuing through the first quarter of 1999. This pattern, though it differed in intensity, was similar to those experienced elsewhere.

In the first stage, large capital inflows might have contributed to—or even exacerbated—the high GDP growth rate with an increase in domestic investment, a decline in savings especially in the private sector, fueling consumer spending. As a result, there was a rapid widening of the current account imbalance from a surplus of 1.5 percent of GDP in 1993 to a deficit of 7.6 percent of GDP in 1996. This rapid deterioration in external accounts might eventually have led to the foreign currency crisis.

The ensuing reversal of capital flows caused the financial conditions to be tightened which has produced the adjustment of external accounts through dampening domestic demand, especially fixed investment, and import growth. The marked slowdown of growth in 1997 was followed by a severe recession in 1998, allowing the current account deficit and inflation to decline markedly. The staff report suggests as the likely cause of recession the prolonged tightening of fiscal and monetary policies, while serious structural deficiencies might as well be at the root of the problems. One could not disregard also developments in the external environment.

The challenge is to implement a policy mix that could stop the deterioration in the economic situation and foster a recovery in a difficult environment. Monetary policy seems to be less effective because of problems in the domestic financial sector, despite improvements in the external conditions. The need to strengthen banks' balance sheets and the poor economic outlook for the enterprise sector continues to depress lending and investment. As the staff pointed out, with the intermediary role of banks impaired, the potency of monetary policy has been reduced mainly to "second order" effects working through a weaker exchange rate and lower debt-servicing costs on the high share of variable interest credits. As the exchange rate appreciates with capital inflows, there seems to be room for some further easing of monetary conditions.

Fiscal policy might have a role. The fiscal deficit would reach 4 percent of GDP in 1999, but with a substantial increase in the output gap the structural deficit would be much lower. The report, however, reminds us of the limited room for further fiscal stimulus. As a result of the structural problems in the budget with tax revenues tending to decline as a share of GDP and a large share of mandatory expenditures exerting mounting pressures on the budget, the deficit is estimated to remain at about 4 percent of GDP over the medium term. If additional infrastructure investment and the contingent liabilities are included, the deficit would reach over 6 percent of GDP and debt over 60 percent of GDP. We agree, therefore, that reforms in mandatory programs are a matter of urgency to avoid an unsustainable evolution of deficits and debt, likely preventing the economy from achieving its potential growth rates and, thus, further exacerbating the fiscal problem.

The openness of the Czech economy and its close trade and financial links to the neighboring countries make the country somewhat subject to developments in these economies. With economic activity weakening in Europe, export growth slowed markedly in the second half of 1998, and tends to continue to be affected by the slowdown in growth in the main trading partners. Therefore, stimulus for economic growth based on expansion of external demand seems less encouraging at this stage. The positive aspect, though, is the continuous flow of foreign direct investment with potential to increase significantly as structural reforms gradually translate into a higher rate of return on capital.

Structural reforms remain, therefore, as an important means to stimulate economic recovery, but these reforms by their nature could take time to be implemented, and their effects would likely be felt only over the medium term. In this area, the challenges facing the authorities are considerable, as pointed out in Mr. Kiekens' and Mr. Jonáš' statement. There is the need to address serious problems in the corporate and financial sector, especially those related to the structures established during the pre-transition period, to the early transition phase especially regarding inadequate or poor privatization, as well as the loose regulation in the aftermath of the privatization process, not to mention the effects of the currency crisis and recession. Therefore, given the limited scope for the usual policy instruments to operate effectively, a timely implementation of structural reforms becomes essential to avoid further delays in economic recovery. Progress in the structural area, if perceived as such domestically and externally, may affect favorably the expectations.

Mr. Milleron made the following statement:

The Czech authorities must be commended for the success of their stabilization effort. Indeed, net inflation has been more than kept under control, and the fiscal deficit is very limited. However, it appears, clearly, that this stabilization has been achieved at the expense of growth, and the question today is to find out what could be done as a remedy without endangering stabilization. Indeed, staff is perfectly correct in emphasizing the delay in the implementation of genuine structural reform and the overall tightening of the policy mix. But we have to remember that the Czech Republic was one of the best performers in the transition economies during the first half of the 1990s and one of the front runners in structural reforms, particularly in privatization. However, and I agree with Mr. Spraos, competition is what matters, rather than ownership, and the problem of corporate governance faced in the Czech Republic suggests that the privatization process has not fully succeeded or, more precisely, did not bring as much improvement as one could have expected. The management of many enterprises did not change, there were a few restructurings, and many enterprises are not yet confronted with hard budget constraints. The latter is due to the difficulty to implement the bankruptcy law and to the banking sector behavior. In this regard, I welcome the revitalization plan, as well as the privatization of the third largest commercial bank, not because of the privatization per se, but because this will help to enhance competition and introduce new technology in this sector. Eventually, more responsible banks will impose financial discipline to the corporate sector.

Now, turning to the policy mix, the staff admitted that it was slow to recognize the need to ease macro policies. One question today is to what extent and how this policy mix can be relaxed a little. First, on the fiscal front, the difficulty is that there is a well-known trade-off between short-term growth and medium-term stabilization constraints. It is not easy to identify the proper instruments, and I share the staff's view that the public sector wage increase bears inflationary risks. Could staff elaborate maybe further on the possible measures envisaged for resolving this dilemma.

Now, on monetary and exchange rate policy, the deep difficulty is that these two elements have to be taken together. Inflation is likely to come well under the target in 1999, suggesting that monetary policy was too tight. Moreover, the increase of the real exchange rate in 1998 reinforces this assumption. Staff says that with the recent depreciation there is little evidence of overvaluation, but recommends that the authorities accept more depreciation and resist appreciation. I agree with this recommendation, and I wonder whether we could not go a little further: could the exchange rate not be used as a kind of reference—not the only reference, but one of the references—for the monetary policy itself? It is true that the interest rates were cut 7.5 percentage points in less than one year. This is huge. So, at this stage, the possible way for a better integration of monetary policy with exchange rate policy is certainly necessary. How could it be done, and what are the instruments to do it?

Mr. Al-Turki made the following statement:

The Czech economy's difficulties have deepened with little prospect of an early turnaround. Significantly, the sizable output contraction last year was investment-led and accompanied by further fiscal deterioration. Notwithstanding marked gains in the terms of trade, the balance of payments has also remained under pressure. As stressed in the preliminary statement by Mr. Kiekens and Mr. Jonáš, an early reversal of these unfavorable trends will require an effective strategy of mutually supportive macroeconomic measures and structural reforms.

As staff acknowledges, the fiscal tightening that the Fund recommended last year may have gone too far. This underscores the importance of budget balance as a goal to be achieved over the cycle rather than at any particular point of time. The recommendation this year for fuller application of automatic fiscal stabilizers and an easier monetary policy stance is clearly appropriate.

The impression of a lack of clarity on a well-articulated medium-term strategy is, however, worrisome. I therefore share staff's priority for adoption of a comprehensive strategy irrespective of the authorities' goal of accession to the European Union by 2003. The authorities' recognition of the need for early correction of the structural weaknesses in the budget is accordingly encouraging. The preliminary quantitative medium-term fiscal policy framework that staff has prepared in collaboration with the authorities is a significant step forward in that regard. The continuation of fiscal deficits and debt build-up highlighted in that exercise points to the importance of moderating wage settlements. Prospects in that regard depend critically on the authorities' ability to set the example in the next round of public sector wage negotiations.

On structural reform, I welcome the authorities' renewed resolve for speedy privatization of the remaining state-controlled banks and revitalization or privatization of the nonbank strategic enterprises. Here, like Mr. Spraos and

Mr. Milleron, I would emphasize that the key to increased efficiency is not in ownership but in ensuring openness to competition. The goals set in the context of the proposed Revitalization Agency are appropriately ambitious. To attract private investors, it is also critical to ensure a modernized business-friendly legal and regulatory framework. Effective bankruptcy legislation, liquidation of non-viable enterprises, and stricter enforcement of existing laws are priorities.

With these remarks, I wish the authorities success.

Mr. Yakusha made the following statement:

Let me start by commending the candid approach of both the staff and the authorities regarding policy in 1998–99. The staff report is to be praised for its frankness, although I must admit that we would have preferred to see in the main report some of the material relegated to the Selected Issues paper.

On a purely technical note, I would like to mention that, as in other reports recently produced by the European I Department, several nontransparent indicators and ratios are used. We do not think, for example, that it is helpful to present the budget deficit so that privatization receipts are above the line, or to use so-called net inflation indicators, or to introduce unexplained definitions of inflows like total non-debt capital. We are also confused by the fact that the amount of Czech official reserves, in months of imports, is shown in many different ways—in two consecutive tables on pages 40 and 41 of the main report, official reserves are shown once in months of current payments, once in months of goods and services, and again in months of merchandise imports. For the Slovak Republic, official reserves were simply shown in terms of months of imports of goods and services and non-factor income. Also, if we were to compare the structure of other tables for these two particular countries, the structures are notably different. These are only presentational issues, but we prefer a more standardized approach to tables and indicators, if possible.

On issues of substance, the staff correctly explained the connection between the Czech Republic's growth performance and the country's structural progress in the banking and enterprise sectors. We also accept that tight financial policies affected the republic's growth prospects. The problem I see, however, is the question of how policy makers and staff can properly assess, ex ante, the appropriate policy response to different shocks. We should not forget the benefit, in terms of continued FDI and capital inflows, that the economy gained from its prudent approach to macroeconomic policy. In our view, we may be using a somewhat simplistic framework when discussing the macroeconomic policy mix. The quality and structural dimensions of relevant policies may matter more than simple adjustment of the overall macroeconomic policy stance. If we look at expenditure policies, for example, the continuing decrease in spending on employment and education, and the increase in spending on public administration, may suggest that the composition of expenditures could have been better. The volume of producer subsidies in recent years may suggest that, at least for some sectors or enterprises, financial results are determined more by decisions in various governmental offices than in the marketplace. We might ask whether incentives provided by such expenditures are conducive to medium-term growth. Furthermore, recent data may indicate that increased consumption has not compensated for the lack of investment, which so far has not responded to monetary loosening. The increasing quantity of outstanding loans guaranteed by the central government suggests that the credit allocation mechanism might be more relevant for medium-term growth than reserve requirements or interest rates. We have seen that actual lending has decreased despite a recent easing of monetary policy.

From a broader perspective, the recent problems of the Czech economy should send an important message to policy makers in other countries, in terms of the sequencing of reforms—many such policy makers might be interested to see that financial tightening is not enough to compensate for slow structural reform. We are not advocating financial relaxation as an alternative to structural reform. In our view, policies for growth rehabilitation are needed, and this rehabilitation should first be based on strong structural measures, and only then on a more flexible role for financial policy. However, I see no danger in further relaxation of monetary policy, as underlined in the staff report. The most important effect of such a loosening would be on the balance of payments, in particular, such a policy might help moderate the current inflows of capital. Also, further interest rate cuts might help address the continued strength of the koruna without major inflationary risks.

I was somewhat puzzled by the staff's surprise at the recent strengthening of the exchange rate, given the drop in inflation, strong capital inflows, and the depressed demand for imports. As for inflation, I share the staff's views that it might be controlled more effectively through wages policy. And on the issue of wage moderation, establishing a hard budget constraint for firms might be more relevant than increasing competitiveness. There is much merit in the more rapidly-paced blueprint of price deregulation recently outlined by the new finance minister, especially in the context of the enterprise restructuring program. This move, however, might push inflation upwards, impacting the real exchange rate and perhaps making wage negotiations more difficult.

Turning to fiscal policies, the problem is how to control the fiscal deficit after a short-term expansion. Perhaps an answer would be to forcefully cut transfers and subsidies over the medium term, in parallel with price liberalization and pension reform. The extent to which that would be feasible is another issue. The staff may wish to provide comments.

The restructuring of banks and enterprises has offered some important lessons. The Czech experience is not unique in demonstrating the limited benefits of a voucher privatization scheme. Therefore, I strongly support the new approach to privatization, which is associated with the industrial revitalization program and is based on strategic investors. A more important element of any such approach, as borne out by the broad experience of other countries, is to increase efficiency and ensure the imposition of hard budget constraints. I agree with the staff that judicial reform measures are needed urgently to facilitate broad-based restructuring, and we would urge the authorities to ensure that such restructuring occurs within a framework of appropriate incentives, not limited to the decisions of a special loan restructuring agency. With the strengthening of the enterprise sector as a first priority, I am confident the authorities will succeed in finding the right way toward sustained growth and macroeconomic stability.

Mr. Mozhin made the following statement:

Nineteen-ninety-eight was a difficult year for the Czech economy. After a noticeable economic slowdown in 1997, the country experienced a deep recession—real GDP fell by almost 3 percent in 1998, and the unemployment rate rose sharply. The slowdown in economic activity resulted from persistent structural deficiencies and a prolonged tightening of fiscal and monetary policies. There is no doubt that tight financial policies played an important role in helping to reduce pressures on the country's external position and to protect the economy from the turbulence in the world financial markets. However, in the absence of adequate structural reforms, the cost to the real economy was high. I agree with the consensus that the policy tightening was perhaps excessive, and that the moment for corrective easing was missed. Furthermore, achieving economic growth requires immediate measures to address structural deficiencies. The main challenge now is to promote a recovery while preserving the macroeconomic stability.

As I broadly share the staff appraisal, I will make only a few comments. The external position of the Czech Republic has improved over the past year. The current account deficit declined sharply, reflecting weak domestic demand on the one hand, and the completion of several large export-oriented investment projects, on the other. At the same time, there were improvements in the terms of trade. However, due to a weakening of economic activity in Europe, and the impact of a real exchange rate appreciation, the Czech Republic's export growth slowed significantly, and even turned negative in late 1998 and early 1999. Given this, I share the staff's view that the authorities should be prepared to accept some additional exchange rate depreciation to support export recovery and enhance the country's prospects for economic growth.

On the other hand, the upward pressure on the exchange rate might be the result of expected foreign direct investment inflows, related to the forthcoming privatizations. Such upward pressure should be resisted through sterilized intervention or, if consistent with the authorities' inflation objectives, additional interest rate cuts. In this respect, I welcome the CNB's decision to cut its key two-week repo rate to 6.5 percent, and the decision to reduce the minimum reserve requirements from 5 to 2 percent. Such steps seem appropriate.

Nevertheless, it is clear that there is only limited room for further interest rate cuts. I agree with the views expressed Mr. Kiekens and Mr. Jonáš that, with interest rates at a low level and abundant banking sector liquidity, further interest rate reductions would have a marginal impact on economic activity, and would only increase the risk of inflation. I also share the staff's view on the need to limit wage increases in the government and state-controlled enterprise sectors. It is also essential to ensure sufficient wage differentiation between flourishing enterprises and those that are not performing well. Further, wage moderation might facilitate further easing of monetary policy, and improved external competitiveness, while keeping inflation within the targeted bounds.

The Czech Republic's fiscal performance in 1998 was somewhat weaker than expected, owing to the economic slowdown. Under the circumstances, it is appropriate to allow the full operation of the economy's automatic stabilizers; i.e., I agree with the staff in urging the authorities to refrain from increasing the tax burden or cutting expenditures in 1999. At the same time, I share the staff's concerns about the country's fiscal prospects, and I urge the authorities to adopt a comprehensive medium-term fiscal consolidation plan. It is regrettable that little progress has been achieved in preparing the 2000 budget, and it is disappointing that the new tax measures recommended by the staff were rejected by the parliament.

As for structural reforms, I would like to emphasize the urgent need to accelerate restructuring and privatization in the banking and enterprise sectors, so as to improve corporate governance and to enhance the efficiency and potential of the economy. The recently announced industrial revitalization program deserves attention, and should be viewed as one way to resolve the problems of distressed enterprises. There are considerable risks with this program, including possible political interference and difficulties with implementing the divestment process. There is also a risk of delay, given the need to attract additional contributors to the industrial rehabilitation fund. In other words, this program should not be considered as a substitute for an effective bankruptcy procedure. It would be appropriate to start with a strengthening of the legal framework, particularly in the area of bankruptcy regulation.

Finally, I have a question on the increasing rate of unemployment. Unlike other transition economies, the unemployment rate in the Czech Republic had been moderate, reflecting the slow pace of enterprise restructuring. However, it has increased significantly over the past two years. I wonder whether this can be attributed to the slowdown in the economic activity, or whether it is also the result of the newly accelerated restructuring process.

Mr. Cabezas made the following statement:

Last year, this Board recommended tight fiscal and monetary policies for the Czech Republic. At the time we did not foresee that the cyclical position of the country was heading towards a much deeper recession than envisaged. The effect of the 1998 recession affected fiscal accounts not only because by a less than expected revenue collection, but also by unbudgeted increases of government expenditures, intended to counteract somewhat the tight fiscal policy maintained until late 1998, in an attempt to offset the depressed stance of domestic demand. For this year's discussion, I feel encouraged by staff's suggestion of letting the automatic fiscal stabilizers work, allowing an increase in the fiscal deficit for 1999 in order not to further dampen economic activity. In this respect, I must say, I am somewhat puzzled by staff's information regarding the better than expected fiscal results during the first quarter of 1999; I would appreciate it if staff could expand on this development specially in light of the worse-than-expected growth scenario for 1999.

On fiscal issues, I concur with the need for quickly establishing a medium term fiscal strategy in order to accommodate the financing of this year's deficit but, most importantly, as a means to building up confidence and trust between the government and the private sector. The fiscal automatic stabilizer buffer can be used only if the private sector believes in the viability of intertemporal switching, that is, if the private sector believes the sustainability of the long-term program is not in jeopardy. The importance of a medium term strategy for the Czech republic is further heightened if we consider the key fiscal issues awaiting to be dealt with in the near future, most crucially the viability of the pension system and the expenses associated with a possible access to EU in the medium term. We call on the authorities to focus their efforts towards the presentation of a medium-term fiscal program as soon as possible, in order to provide the country with a medium-term planning horizon.

The complicated medium term prospect of fiscal accounts presented in the staff report casts doubts about the appropriateness of the voucher privatization scheme applied in the Czech republic. The voucher privatization scheme, matched with an inadequate capital market legal framework, not only generated important governance problems to the newly distributed enterprises, but also deprived the government from part of the financing required for the important structural changes needed for its economy. Staff comments are welcomed.

After the recession experienced in 1998, the country needed an engine of growth. Most surely, an improvement in the competitive position will help the country to increase its share of international trade. After facing an important real recuperation during the past years, wage settlements need to ease their pace of expansion in order to help the contention of further real appreciation of the koruna (ULC-based computations). For the immediate future, and given the slow prospects of growth for 1999 and 2000, it is advisable to opt for more moderate real wage increases than in the past. In attaining this objective, the restraining signal that the government can send to the market in its own wage negotiations is of utmost importance. As noted by staff, unions have agreed to a zero real increase for the incoming wage settlements, and discussions are now centered around acceptable inflationary projections. As other speakers, I believe that a long term compromise can be reached between the authorities and the unions that might allow for adjustments in the event that some inflationary forecasting mistake materializes. This can help not only to settle the negotiations but to continue the building of credibility in the inflationary targets set by the central bank. It should be noted, however, that ex-post compensations should be partial if one wants to avoid a full inertia in the inflationary process.

On balance of payments issues, as noted by staff, the reversal of the deteriorated external position that the country exhibited during 1997 and 1998 has been mainly the product of the downturn experienced by the economy rather than of a structural reversal in the external competitiveness, which casts doubts about the appropriateness of the level reached by the real exchange rate. With inflationary pressures under control, the country could deal more aggressively with the important external imbalances shown in the past by allowing the accommodation of a more depreciated exchange rate than the one envisaged in the staff report, a rate that proves instrumental in the recovery of the export sector and in enhancing growth prospects. In Box 1 staff presents a computation for the structural current account balance for 1999 in the Czech republic, it is estimated to be around 4 percent of GDP. This result, even though in line with the medium-term prospects for the balance of payments, still runs in the high side, and its sustainability depends crucially on the assumed capital flows, a risky bet, especially taking into consideration the rapid reversals that capital flows tend to experience in transition and developing economies. Such a risk may be unwise in the case of the Czech republic where private sector investors might be particularly sensible to sudden market developments due to the lack of a medium-term perspective on the authorities' policy decision-making. At this time, and due to unexpectedly high capital inflows attracted by the announcement of privatization, the koruna is under appreciation pressures; this should be the moment to restrain from further appreciation by allowing interest rates to decrease. At the same time, the government should devote efforts to help the development of the export sector, in preparation for a needed real exchange rate alignment with a level compatible with a more prudent medium-term stability. In this regard, we welcome the incentives that the government is giving to the export sector through subsidies, but expect that their introduction will not translate into permanent budget allocations. Maybe staff can update us on this subsidy scheme being utilized to support exporters at this time.

On structural reforms, the country needs to urgently address the problems that still show in its legal and institutional framework, in order to provide the proper incentives for business activities. In this regard, the establishment of an enforceable bankruptcy system is of utmost importance. I concur with staff on the importance of an amendment to both the commercial code and the investment fund act, that after the voucher privatization took place has shown its inadequacy. The progress in the legal framework are linked crucially with the introduction of the revitalization plan approved in April. With more government financing support for the private sector, the legislative framework under which this support will be administered acquires further importance. In this respect, I would like staff to comment on the sequencing envisaged for the introduction of the regulatory changes, specially the effective functioning of the newly appointed securities commission and the investment fund act. Are these changes envisaged to be in phase with the materialization of the public intervention in the troubled privatized enterprises?

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

Mr. Lehmussaari made the following statement:

The staff papers present a somber picture of the Czech economy. Improvements since last year, such as the lower inflation rate and a marked decline in the current account deficit are significant, but they are overshadowed by the weak economic activity and continued serious structural deficiencies. As it appears gains in external adjustment and disinflation were partly lost in a sharp deterioration in the economic situation and an increase in unemployment.

I broadly share staff's assessment and policy recommendations, but let me emphasize two important points.

First, on economic growth, we have seen a steady decline in economic activity since 1995, but the dip last year and the first quarter this year were indeed unusually large. This is to some extent mind-boggling, because economic activity in some of the other countries in the region such as Hungary, Poland and Slovak Republic has been relatively brisk. Staff, as well as most other experts, were far from foreseeing this decline at the time of last year's

Board discussion. As a result, the advice provided then by staff and the Board on continued fiscal restraint and tight monetary policy, which admittedly did contribute to a more viable external position, also, however, contributed to making the decline in growth more pronounced.

There is now a need to focus on reviving growth. More stimulative fiscal policies are called for with a view, however, that a clear medium-term fiscal strategy is put in place so as not to cement expenditures at an unsustainably high level. Against this background, the staff is right to have provided a first attempt to quantify the medium-term fiscal outlook for the Czech government. Medium-term fiscal calculations presented by the staff paint, however, a gloomy picture on the fiscal outlook in the following years. On this point, it is reassuring that the authorities are committed to press ahead in this area in collaboration with the Fund staff and, in fact, this is a "must" and a part of the EU accession process.

In addition, a wide range of structural measures will have to be taken in order to remove bottlenecks to growth. More efficient financial and industrial sectors will have to be developed in order to increase investors' confidence. Bankruptcy and foreclosure laws need to be enacted. Also measures are needed to improve creditor protection and property rights. Furthermore, the privatization process must be carried out with the view to improve efficiency of corporations. The change of ownership is not enough—managements have to be changed and tighter wage policies adopted.

Second, a comment on the high nominal wage increases. This has been a feature of the Czech economy for several years (from 1994), and the Fund has repeatedly expressed its concerns on this point. I very much share these concerns. It is indeed troubling, to say the least, that in an economy which contracted by roughly 3 percent in 1998, and with hardly any growth in sight for 1999, wages are leaping forward by 7–8 percent in the private sector and even more in the public sector. In the current environment, companies may find it very hard to accommodate such wage increases which would be reflected negatively in employment. The question is what can be done? According to the OECD, the excessive wage increases in Czech Republic are not likely to have been generated by a poorly functioning wage bargaining system. The authorities point to sticky inflation expectations as the major problem. If this is the problem, I urge the central bank to take further steps in promoting its inflation target and to establish credibility for it. With this in mind, it appears that there is a need for a more intensive communication with the social partners and market participants, with the aim to explain in a credible way the objectives of the monetary policy. If the inflation targeting is to succeed in the medium run, the authorities should make all efforts to contain wage pressures and, in particular, the government should show leadership in this area, as rightly pointed out by the staff.

> Finally on this point, I believe, like Mr. Spraos and staff, that the idea of introducing catch-up clauses in the wage agreements could be further considered.

The Deputy Director of the European I Department, commenting on the policy choices that had been made in 1997–98, remarked that there had been a serious balance of payments crisis in 1997, which had reflected major macroeconomic and structural weaknesses. At that time, there had been no alternative other than to cut nominal domestic demand. It was debatable whether the authorities had reacted excessively, but he considered that their actions had been appropriate—they had acted decisively to stop the crisis quickly and effectively. Problems arose, however, during 1998. The Czech Republic's 1998 Article IV consultations took place on the basis of information available at the beginning of the year, when external demand was weak, inflation remained high, and economic activity appeared robust. In that light, the budget for 1999 had not been unreasonable. Similarly, given what was known at the beginning of 1998, it was difficult to claim that the authorities had been mistaken in not cutting interest rates further. However, similar excuses did not apply to the policy choices of the authorities and the staff throughout the second and third quarters of 1998. During that period, it had become clear that economic activity was much weaker than had been forecast, and so it would have been better for the authorities to have allowed a greater role for the economy's automatic stabilizers. Unfortunately, the concept of such stabilizers was not widely appreciated within Czech policymaking circles, and so, confronted by falling revenues, the authorities had simply cut expenditures. Although the Fund did not have a mission in mid-1998, by the third quarter the staff should have been more aggressive in stressing that the authorities' fiscal path was perhaps misguided.

The monetary policy issue was more complex, the Deputy Director continued. It had been argued that, by mid-1998, as it became clear that economic activity was weaker than anticipated and that inflation was falling rapidly, the central bank should have cut interest rates further. However, during that period there was a financial crisis in Russia and in other emerging markets. And at that time, it was not possible to know how much of an impact such turbulence would have on the Czech economy. The staff were certainly concerned about the potential implications for central and eastern Europe, as was the Czech central bank. Although, with the benefit of hindsight, the decision not to cut interest rates further was unfortunate, the choices of the authorities were understandable, as was the staff's reluctance to press the point.

Some Directors had questioned whether, given that tight monetary conditions and prudential requirements were the main causes of the banking crisis in 1997–98, the Fund should have argued for a more gradual strengthening of prudential rules, the Deputy Director commented. He disagreed that the tightening of prudential rules had been the main cause of the deterioration in the banks' financial positions. The tightening had simply made an existing problem more transparent. The position of the staff was that strengthened prudential requirements were appropriate then, and were still appropriate in the current climate.

Moving to 1999, there might be scope for further interest rate reductions, particularly if economic activity remained flat and the exchange rate remained strong, the Deputy Director remarked. The repo rate of 6.5 percent was high, considering that inflation was effectively zero. Even accounting for various temporary price factors, the real interest rate was still around 4 percent. That did not mean that such a policy of interest rate cuts was necessary, it only meant that there was room for such a move should it be needed. As for the suggestion that the exchange rate be used as a reference target when setting monetary policy, the current monetary framework had been changed only two years ago—and that change had been from an exchange rate-based framework to one that was based on inflation targeting. To change the framework again would undermine the credibility of the authorities' monetary management. Also, movements in the exchange rate were being considered in monetary policy decisions, albeit in an asymmetric manner. It was generally understood that the economy could not afford a further loss in competitiveness arising from additional appreciation of the currency. However, there was little concern about the possible ramifications of a depreciation, and so it did not make sense to increase interest rate to support the currency at a particular level.

On fiscal policy, the budget for 1999 was broadly appropriate, given the circumstances, the Deputy Director said. However, the budget had assumed that economic activity would stabilize or increase, and that was not happening. In the first quarter of 1999, the authorities had again cut all discretionary spending to match the current weakness in revenue. The situation was similar to that in 1998, in that the authorities were again providing a negative stimulus to the economy. This time, however, the staff had stressed that the authorities should allow the deficit to play a stabilizing role. That would likely involve a significant increase in spending over the second half of 1999.

On incomes policy, the labor unions had not expected inflation to fall rapidly to zero, the Deputy Director remarked. In addition, the authorities themselves had not believed that such a drop was possible, as they had accepted a 1999 government wage increase of around 14 percent. Given that a large part of the rest of the economy was not subject to competition, wage bargaining adjustment throughout the country would be a rigid and sluggish process. When setting public sector wages in the next budget, it was essential for the government to assume zero inflation.

On structural reform, the Czech authorities were committed to joining the European Union, and therefore would be likely to move on a number of associated structural issues, such as competition, the Deputy Director commented. Unfortunately, the pace of progress had been limited, including for those programs assessed by the European Commission. The Fund could only provide its views on what should be done. As for the question of ownership versus competitiveness, competition was clearly important for increasing efficiency. However, the two issues were closely related and needed to be tackled at the same time—the experience of the banking sector had shown the limits of competition in a situation where all the major banks belonged to the same owner.

As for the fate of less successful enterprises that were not scheduled to participate in the revitalization program, there was no firm answer at present, the Deputy Director remarked. The bankruptcy process was not working and the Czech authorities were trying to improve the situation. However, the necessary legislation required the support of a majority of the parliament. In addition, a functioning legal framework was required to implement that legislation, and such a framework did not exist as yet. Overall, therefore, a rapid solution to the problem was unlikely.

The unemployment rate had increased considerably, the Deputy Director noted. Although much of that had been the result of the general economic slowdown, part of that increase had also been due to the restructuring effort.

On the question of a more standardized staff presentation for European I countries, although there was certainly room for improvement, the main challenge for the staff was to communicate effectively with the authorities, the Deputy Director pointed out. To do that, the staff had to start by using the concepts that the authorities used. For example, the Czech authorities were targeting a specific "net inflation" indicator, and so the staff were bound to consider that figure. Similarly, the staff report had presented the budget in two formats: one with privatization proceeds above the line; and one with the proceeds below the line. Although the staff would have preferred to only include the latter version in the report, the authorities used the first version.

Responding to a question from Mr. Mozhin and Mr. Szczuka, the Deputy Director confirmed that the industrial revitalization program was, to an extent, a form of renationalization, and that the staff was concerned about some aspects of the program. At the same time, the problems of some non-viable firms were pressing, and it was not realistic to expect the authorities to wait until a complete judicial and legislative framework was in place. The revitalization program was considered fairly straightforward and should work well. Enterprises that were faring poorly under their current management would be renationalized via a debt-equity swap to cover any existing bad debt to commercial banks, and then sold to strategic foreign investors. Such investors would bring managerial and financial skills, and would have an added level of expertise on selling products abroad. The main risk, however, was that the program might work poorly, as the government could face political pressure to apply the program to large, non-viable firms for whom there was no strategic foreign investor. That would leave the authorities with an under-performing public asset.

Mr. Donecker commented that the authorities should be encouraged to focus more on the development of small- and medium-scale enterprises, as the Czech economy seemed to be dominated by large firms, and it was generally the case that smaller-scale private enterprises were the most dynamic elements of an economy.

Mr. Donecker made the following statement:

> Since we support the main recommendations of the well-focused staff document, I should like to concentrate on the issue of monetary policy where we seem to have a somewhat different view than staff.
>
> Staff makes—admittedly in a very guarded way—the case for some further monetary easing given the economic stagnation, the lack of evidence of

any significant inflationary pressures and in view of current upward pressures on the koruna. Staff therefore welcomes the most recent further lowering of the key 2-week redo rate on June 24. In our view the authorities should, however, be very cautious in using this tool further for the following reasons:

First, inflationary pressures may quickly resurge hampering the achievement of the goal to converge the inflation rate with that of the European Union. There are also still substantial inflationary expectations among market participants such as trade unions and consumers. Staff himself points out that there have been delays in adjusting inflationary expectations to the rapid decline in inflation. So the recent credibility gains of monetary policy could be rapidly lost again. In this context, we also share staff's concern that the large wage increases in the government sector and the railways in 1999 have sent the wrong signal to the enterprise sector. Staff's hint, supported by Mr. Spraos, to give further thought to low initial settlements with lagged catch-up clauses seems fairly convincing since it may ease the unions' distrust of inflation forecasts; it is, however, certainly no panacea. There is the risk that this catch-up would lead to a full compensation for inflation triggering a spiral of wage increases and inflation.

Secondly, as noted in Mr. Kiekens' and Mr. Jonáš' candid and comprehensive preliminary statement, in light of already low interest rates and abundant liquidity in the banking sector, further significant cuts in interest rates by the central bank are likely to produce only marginal effects on economic activity, but would heighten the risk of instability in the foreign exchange market.

Thirdly, interest rate cuts primarily aimed at mitigating the upward pressure on the koruna are not advisable. Such a strategy in all probability would overburden the Czech National Bank by asking it to credibly pursue inflation reduction and exchange rate stabilization simultaneously.

Mr. Hinata made the following statement:

At this stage of the discussion, I can be brief. I broadly support the thrust of the staff appraisal, but would like to comment on some points.

It is appropriate that the authorities have taken an easing stance on both fiscal and monetary policies in response to the economic downturn, such as increasing capital expenditures in the 1999 budget to stimulate the economy. Given the lack of evidence of inflation pressure and a decreasing 1999 current account deficit projection, I agree with the staff in encouraging an easing of the monetary stance as much as possible in order to further improve the credit condition. In this context, I welcome lowering of the CNB's 2-week repo rate in June.

On the other hand, as the staff correctly pointed out, a weakening of economic activities resulted mainly from a lack of effective privatization and of banking and enterprise sectors restructuring. It is important not only to stimulate the economy with fiscal and monetary measures, but also to further accelerate implementation of structural reforms, such as restructuring the economy, privatization, and strengthening the banking sector. To ensure fair competitiveness and the smooth elimination of less competitive cooperates, like other speakers, the authorities should improve the legal framework, especially the bankruptcy act, as well as the judicial framework. These improvement might also contribute to attracting foreign direct investments.

On the financial sector front, the poor governance of financial institutions caused the overheated economy, and nonperforming loans still remain at about 18.5 percent of total loans. Having said that, the Czech banking system should be strengthened urgently. It is necessary to establish a financial system that can provide significant resources to promising corporations through improvement in risk management; for example, by acquiring know-how from foreign banks, and strengthening the central bank's supervision. In this connection, I welcome that the authorities announced a timetable for the privatization of two remaining banks in 1999. I hope the authorities will be able to adhere to the timetable for implementation of privatization.

Mr. Kudiwu made the following statement:

Fostering a sustainable recovery and preserving the gains achieved so far will remain the major challenge facing the Czech Republic. In this connection, the pursuit of prudent financial policies and addressing structural problems, as noted by previous speakers, will remain crucial to the achievement of potential growth. With the intention for entry into EU by the year 2003, a workable strategy to achieve medium-term fiscal sustainability is needed.

I, therefore, commend the authorities for achieving a balanced budget in 1998, despite the severe downturn in economic activity. For 1999, I welcome the fact that the fiscal budget is oriented to stimulating growth, mainly through the increase in public investment. However, owing to the severity of the recession and the related pressures, achieving the planned recovery of the economy will be a serious challenge for the authorities. Therefore, the prudent policy measures recommended by staff should be forcefully implemented, in order to limit the deterioration of the fiscal situation and avoid the build-up of debt over the medium and long term. Due regard should be paid to increased transparency in fiscal management and steps toward harmonization with EU standards should be taken carefully.

On monetary policy, the authorities are to be commended for the cautious approach adopted during most of 1998 to stem the contagion pressures from the international financial crisis, and which contributed to bringing interest rates down in line with the decline in inflation. In order to maintain inflation at a lower level, wage policy should be managed carefully, so as to ease the fiscal burden on monetary policy and to improve external competitiveness. It is also encouraging to note that there is further room for additional cuts in interest rates, essential to promoting economic growth.

As regards the financial sector, due attention should be paid to the issue of large nonperforming loans. The steps taken recently to adapt the prudential and supervisory framework to EU norms and BIS standards are encouraging. Other actions for establishing rules and legal provisions for consolidated supervision and better reflecting market risk in capital adequacy calculations should also be considered carefully.

Finally, regarding the public enterprise sector, although progress was made in strengthening the regulatory framework, several shortcomings remain. In particular, as suggested by staff, there is a need to strengthen the enforcement of existing laws and regulations.

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

Ms. Wang made the following statement:

As the staff pointed out in the executive summary, the positive development in the Czech economy in 1998 was the sharp reduction in the current account deficit and inflation. We commend the authorities for their achievements in these two areas. However, the Czech Republic's experience last year also provides us with another example of obtaining macroeconomic stability at the cost of real economic growth. While understanding that the lack of progress in structural reform was the deep-rooted reason for the economic recession in the Czech Republic last year, it is unclear from the staff report what features in the Czech structural reform distinguish it from other transitional economies in the region when the latter have registered rapid growth since 1997. How to revive economic growth while maintaining their hard-won stability and put the economy on a long-term sustainable growth track is the challenge facing the authorities.

First, on monetary policy, we welcome the authorities' recent cut of the key two-week repo rate which is consistent with the staff's recommendations. The question now is whether there is room for a further interest rate cut. While I agree that if the currency is under further appreciation pressure, and the inflation pressure is on a continued declining trend, the interest rate should be cut to maintain export competitiveness and promote growth, we doubt its effect in stimulating economic activities, since, as the staff mentioned in the paper, the transmission of monetary policy is weak due to the virtual breakdown of the credit channel to a large part of the enterprise sector.

Second, on fiscal policy, given the limitations of monetary policy in stimulating the economy, fiscal policy should take the major responsibility in prompting domestic demand. However, it seems that the government is more concerned about the medium-term sustainability of the fiscal balance, and is reluctant to let the automatic stabilizer function fully. This is demonstrated by the fiscal outcome for the first half of 1999. In light of the traditional prudent fiscal philosophy, the authorities' attitude is quite understandable. However, as Mr. Kiekens and Mr. Jonáš mentioned in their helpful preliminary statement, the severity of the economic downturn in 1998 has given the authorities no other choice. Therefore, we join the staff in encouraging the authorities to allow the full functioning of the automatic stabilizer, and take necessary addition measures to ensure that the revised budget deficit target is met and sufficient stimulus provided to the economy. Given the low level of government capital expenditure, we believe that productive ways should be found for government expenditure.

Third, on structural reform, we share Mr. Spraos' view that with accession to the EU as the spur, structural reform in the Czech Republic will be implemented and on a much wider front than encompassed by the Fund's surveillance. As regards privatization, we share his view that competition, not ownership, is the most critical factor in increasing efficiency. We also doubt the strategy of selling the good assets to strategic foreign investors and liquidating the bad ones can have lasting political support. However, we share the staff's view that efforts should be strengthened in the legal and institutional framework. In our view, the lack of attention and progress in this regard might be the major reason preventing the Czech Republic from making greater progress in its transitional process.

With these remarks, we wish the authorities success in meeting the challenges ahead.

Ms. Brukoff made the following statement:

Our thanks as well to staff for providing a very detailed set of papers. The boxes on competitiveness and bankruptcy were particularly informative, as well as the papers in selected issues that provided greater focus to topics treated in the staff report. Since the staff work has been so thorough, I can be brief.

At time of last Article IV discussion, staff and Directors emphasized the need for concerted external adjustment to counter pressures emanating from the crisis in emerging markets, as well as reiterating their long-standing recommendation to redouble efforts on the structural front to achieve much-needed internal adjustment.

The authorities have achieved the first goal, apparently tightening enough to provide the economy with a buffer against subsequent waves of external pressure. These tight macro policies have strengthened the country's external position, providing important scope for sustaining a larger C/A deficit necessary to achieve investment-led closure of the output gap. However, we would note that a higher external deficit is sustainable only if inflows are used productively, not to prop up inefficient unrestructured enterprises. It is also important that this tightness not be overdone going forward; care should be taken that over-reliance on these levers does not choke off prospects for recovery. We paid particular attention to staff's concerns about competitiveness and the importance of avoiding further exchange rate appreciation.

On the second issue of advancing the country's structural reform agenda, while there has been some movement over the past year, the full potential of the Czech economy remains unrealized as the same set of critical problems goes unaddressed. Now that the country is turning its attention to meeting requirements for EU accession, the authorities seem somewhat more attuned to the exhortations repeated over the past few years by staff and this Board to accelerate their efforts in this regard. We hope this is the case, because achieving the authorities' goals of EU accession and economic sustainability is inexorably tied to making progress on these long-standing issues.

There have been some important positive developments on the structural front. In the banking sector, we welcomed signs that the authorities are accelerating bank privatization and the sale of strategic state-owned enterprises, as well as their decision to prohibit deduction of collateral from banks' required provisions. This was clearly a difficult step for country's banks but a prudent one that showed recognition of continued weakness in banks' real ability to exercise the foreclosure option under current circumstances. It also appears that new efforts are under way to improve capital market regulation and strengthen the legal and institutional framework for addressing problems of corporate governance. Finally, the authorities' increased commitment to transparency is to be commended, particularly with respect to their decision to participate in the pilot project on release of Article IV reports.

The Revitalization Plan is a potentially positive contribution to the structural reform agenda, but we will reserve judgement until we see how it is implemented. If it functions as described, it could have a big pay-off in terms of strengthening the enterprise sector. However, great care must be taken to ensure that the agency is fully independent and allowed to use its discretion in selecting firms for participation in the plan.

While these signs of progress are encouraging, we also note the worrisome developments highlighted by staff, particularly in the area of fiscal policy. The medium-term fiscal projections are rather daunting, even under relatively optimistic assumptions. Unaddressed structural problems with budget are coming to the fore just as EU accession costs will begin to hit. Wage restraint, which was viewed as a critical element in strengthening the country's fiscal position and containing inflation expectations during the last Article IV discussion, is still not apparent, as once again we read about government sector wage increases that send a poor signal to the rest of the enterprise sector. Similarly, the authorities' decision to increase enterprise subsidies in response to the sharp economic downturn is another unproductive policy reflex that needs to be resisted. Given the apparent broad agreement between staff and the authorities that the current fiscal policy framework will not achieve desired results, we would hope that the authorities' efforts to address these and other recognized problems will be quick and substantial.

In closing, the experience of the Czech Republic provides a clear lesson that only so much can be accomplished with strong implementation of macroeconomic policies in the absence of sufficient structural adjustment. Unless the internal financial and industrial structure is appropriately revamped, real recovery, growth, and EU accession will remain elusive. It is our sincere hope that the worry and pessimism expressed by authorities in these discussions with respect to inflation, debt, and growth prospects will now motivate them sufficiently to address the unfinished agenda of enterprise, banking sector, legal/regulatory, and other vital structural reforms.

Mr. Szczuka made the following statement:

I would like to ask the staff a few questions. The main question is what went wrong. The Czech Republic has the potential to be a leader among transition countries—I trust that this potential will be used, and I share the confidence of foreign investors who will continue to invest on a substantial scale.

The question of what went wrong is clearly a question of determining the relative contributions of the economy's structural deficiencies and the authorities' policy failures. In my view, the policy failures have played an important role, and I could start here by arguing that orthodox financial policies are not sufficient to guarantee success in transition. Clearly, they have to be supported by structural, legal and other reforms. The Czech example provides a reason to have a broader debate on voucher privatization, and on privatization more generally, as requested by Mr. Sivaraman some time ago.

Another example of a failed policy is the bank restructuring program, which has come at a very large cost to the budget, about 10 percent of GDP, and has still not solved many of the existing problems. This is clearly an example of poor policy implementation. An additional issue is the role of the broader political framework, where the government does not command a majority in parliament, and does not have the ability of pushing through necessary legislation. This is a question which should be studied in more detail for all transition countries; i.e., what is the impact of the political framework on the reform process? The answer may, in part, explain the difference between various transition countries. It is a broad question, and I do not expect a complete answer today, but I am concerned that this issue is not yet fully understood by political actors in the Czech Republic. The budget surplus in the first quarter is worrying, and the oppositions' charge that the government has failed in implementing the budget targets is a sign that a number of political actors do not understand that there is a need to change the overall approach to fiscal policy.

I would be grateful for the staff's assessment of the risk of inflation. As Mr. Donecker indicated, inflation has not yet been eliminated in the Czech Republic, and there is a strong link between depreciation of the currency and inflation, as we observed in 1997. We also have a situation where wages are growing rapidly. In addition, I would like the staff to comment on the risk of a problematic current account deficit in the event of an output recovery.

I also have a question on the authorities' plans to borrow up to 2 billion euro, despite concerns about renewed pressure on the currency. I wonder whether the staff supports the government's intention to borrow from the international capital market at this particular time.

The immediate future of the Czech Republic unfortunately seems to involve a relatively slow recovery. I don't see any factors that might produce a more rapid recovery—export demand is not present, and domestic investment will remain weak. The appropriate way forward has been presented in the staff report, and involves a further easing of policies. On monetary policy, I tend to agree here with Mr. Milleron that a more direct association between interest rate policy and exchange rate policy should be considered, given the relatively low risk of inflation. In light of the limited capacity of monetary policy to stimulating the economy, interest rate policy should focus on guaranteeing that the exchange rate will not become overvalued.

That leaves fiscal policy and structural reforms. Unfortunately, the most important element is being blocked by the current political climate. I wonder whether the staff report's advocacy of prudent financial policies might be misunderstood as arguing for tight policies. That might be another wrong signal.

Mr. Pascual made the following statement:

All in all, I could not agree more with the thrust of the staff appraisal. The diagnosis of the country's problems is accurate, and the candid recognition of past errors is most welcome. This will undoubtedly help to find more appropriate solutions to present and future challenges.

This being said, I would like to refer briefly to some issues pointed out in the reports. The policy mix implemented during 1997 and 1998 has not been optimal, and the effects on growth have been evident. On fiscal policy, weaknesses have stemmed from the structural components of the budget, while the lack of effectiveness of monetary policy stems from a deterioration of traditional transmission channels owing to the overall economic transformation process. So, what could the authorities have done differently? Should their fiscal policy have been more expansive? Public debt levels are not excessive, so this has not been a serious constraint in deciding the fiscal stance. It was the dangerous medium-term trend, that both the staff and the authorities recognized, and the need to alleviate a sizable external imbalance, that were the most compelling reasons to take such a restrictive stance. Under these circumstances, I understand the authorities' tendency towards a more balanced budget.

Others have mentioned that, with the benefit of hindsight, we can characterize the policy mix as excessively restrictive. I am not so sure. Given the structural deficiencies of the economy, the consequences of a more lax policy mix might have been even worse. Internal and external imbalances might have grown, and the restructuring process could have been more difficult to carry out. Therefore, I would encourage the authorities to address the main structural issues affecting key functions of the economy. This should be done as soon as the general conditions of the economy allow.

We understand that the authorities are considering a more flexible approach which will allow a wider and freer operation of automatic fiscal stabilizers in the short-term; i.e., the second half of 1999 and 2000. We also learn from the staff about a medium-term consolidation program, coupled with a set of reforms to correct those structural deficiencies that impair the budget's sustainability. This is good news. On the one hand, they have designed a medium-term fiscal path compatible with more general macroeconomic and political objectives—namely EU accession. On the other, the authorities recognize the role of fiscal policy as a counter cyclical tool in the short run within the framework of the medium-term scenario.

In this light, it is crucial for the authorities to work out a clear and comprehensive medium-term scenario that includes precise targets. This exercise is essential for the planning and execution process—it will compel the authorities to consider all foreseen alternatives and costs, and will allow a quick identification of deviations and the adoption of corrective measures when needed.

Having a medium-term macroeconomic scenario, the definition of medium-term fiscal targets should be easier. Most of the staff's recommendations on the structural deficiencies of the tax system, and the sustainability problems of the pension system, should be followed. On the precise targets for 1999 and 2000, I share the staff's concerns on the implementation of fiscal policy. The current increases in transfers and subsidies to enterprises run the risk of making restructuring more complex by relaxing financial constraints.

On monetary policy, being in overall agreement with the CNB medium-term strategy, my only concern is on exchange rate policy. Although I concur with the staff on the need to avoid any further appreciation of the koruna, I would warn the authorities against the regular use of the exchange rate to compensate for competitiveness problems stemming from a lack of internal adjustment.

We have learned from the staff about the disappointing wages outcomes and a consistent deterioration of company finances. Under these circumstances, measures to manage the exchange rate, subsidies and transfers, and the financing of loss-making companies, run the risk of delaying the adjustment and making the situation worse.

That is also my concern with the restructuring of banks and enterprises, and with the industrial revitalization program. With the staff, I encourage the authorities to avoid any temptation to delay much-needed restructuring. Therefore, the use of these mechanisms to allay the painful effects of the crisis, although respectable, must be confined to exceptional circumstances. Further, they should persist only until the structural reforms have been implemented, especially those related to the improvement of supervisory activities and good governance.

On the particular issue of structural reforms, I encourage the authorities to follow the staff's advice. A comprehensive program should be designed and implemented to improve the general legal framework and create a business-friendly environment. Bankruptcy procedures, financial supervision, law enforcement, and judicial reform are all needed to enhance economic efficiency, accelerate the restructuring process, and attract foreign investment.

I am convinced that once all these measures are adopted, the future will be brighter. My best wishes to the authorities in these endeavors.

After adjourning at 1:10 p.m., the Executive Board reconvened at 2:35 p.m.

The Deputy Director of the European I Department remarked that he agreed that the privatization voucher scheme had not worked as well as expected. The authorities should not have stopped with the issue of vouchers, which was only the first step. That had resulted in most of the vouchers being held by the commercial banks, which were in turn owned by the state, thus creating a diffuse system of ownership with little corporate governance. Instead, the authorities should have moved more rapidly toward bank privatization and the installation of the required legal and bankruptcy framework. That would have helped the concentration of ownership in the hands of strategic investors.

The recovery would be slow, the exchange rate would remain strong, and wage demands seemed to be moderating, the Deputy Director continued. The risk of inflation did not seem to be a pressing concern. As for the risk of an expanded current account deficit, weak domestic demand and increased activity in western Europe meant that this was unlikely to become a problem over the next 18–24 months. Furthermore, on the capital account, the staff expected increased inflows of foreign direct investment, owing to the privatization of large segments of the economy, including the banks. Nevertheless, balance of payments problems might be a concern over the medium term, as output recovered and the strong exchange rate affected the economy's external competitiveness. Similarly, there might be a problem with the budget over the medium term that would impact the country's external accounts. However, the immediate priority of the staff was to secure an economic recovery and encourage structural reform.

Mr. Kiekens stated that he agreed with the staff's assessment of the policy choices that had been made over the past two years. Any judgment of those choices should consider the information that was available at the time. In that light, the authorities' approach to monetary policy had proven to be quite flexible—they had been willing to adjust policy as soon as new information had become available, and had reduced interest rates substantially. Further, the authorities could not have been expected to be too ambitious in relaxing monetary policy during the crisis of July–September, 1998.

On the issue of ownership versus competition, the Czech experience had shown that privatization alone did not guarantee results, Mr. Kiekens continued. Also needed was a private ownership structure that facilitated financial discipline and good corporate governance. He asked that the nuances of the Czech experience be reflected in the Acting Chairman's summing up.

During the recent review of Thailand's Stand-By Arrangement, his chair had insisted that bankruptcy and foreclosure laws be adopted as a condition of the completion of the next review, Mr. Kiekens recalled. The Czech Republic now found itself in the same position as Thailand, in that the Czech political climate was preventing many worthwhile measures from being passed through the parliament. Nevertheless, the Board should still clearly, and insistently, advise the Czech authorities to have all necessary structural reforms implemented.

Adoption of those reforms would not only enhance overall economic efficiency, but would also increase the value of the banking system, which was still to be privatized, Mr. Kiekens remarked. Further, he acknowledged that privatization of one or two banks was not sufficient. A fair and competitive environment between banks was needed, and so the Acting Chairman's summing up should indicate that privatization of the broad banking sector should be implemented as soon as possible.

Mr. Spraos commented that, having decided on privatization, a large-scale voucher scheme might have been unavoidable. However, there were still other options available to the authorities, short of privatization. By focusing on privatization, the authorities might have paid insufficient attention to possible improvements to the state-owned sector; efforts to improve governance, introduce more rigid budget constraints, and promote professional management, might have increased efficiency.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for maintaining a prudent macroeconomic policy, which had allowed the Czech economy to maintain a strong external position and relatively low inflation despite the turmoil affecting other emerging markets in the past year. However, Directors observed that deep-rooted problems in the banking and enterprise sectors, which remained unaddressed, compounded by the tight policy stance, had sent the Czech economy into a severe recession. Several Directors considered that, at least with hindsight, an earlier loosening of fiscal and monetary policies, including a full use of automatic fiscal stabilizers, would have been desirable. Some other Directors, however, stressed the benefits of the authorities' clear policy stance in the midst of a crisis and the authorities' traditional preference for balanced budgets.
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> Directors agreed that the recent easing of fiscal and monetary policies was appropriate to revive activity and promote employment in the short term. However, they stressed that to ensure the sustainability of economic growth in the longer term, as well as to prepare for EU accession, it was crucial to address the underlying structural weaknesses in the banking and enterprise sectors.
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> Regarding short-term macroeconomic policies, Directors considered that, with activity depressed, it was no longer appropriate to hold the fiscal deficit to the level envisaged in the 1999 budget and recommended that fiscal stabilizers be allowed to operate. Directors welcomed the easing of monetary policy by the Czech National Bank. In light of uncertainties about external competitiveness and export performance, Directors generally agreed that upward pressure on the koruna should be resisted through intervention or further cuts in interest rates to the extent that this could credibly be viewed as consistent with the medium-term inflation target. A few Directors went further

and considered that some depreciation of the koruna would enhance prospects for recovery, especially as inflation was well below the authorities' target. A few other Directors, on the other hand, cautioned against undue monetary easing, so as not to rekindle inflationary expectations. More generally, Directors agreed on the importance of a clear and credible monetary policy in establishing the expectations of wage bargainers.

Directors stressed that wage moderation would facilitate monetary easing and also improve external competitiveness. They expressed concern that wage growth had been slow to respond to the lower inflation, and that wage settlements for 1999 appeared to be well in excess of expected inflation. Directors considered that the large public sector wage increases agreed for 1999 had sent a poor signal to the enterprise sector. They stressed the importance of the government's showing leadership in the 2000 wage negotiations by limiting wage increases in the public sector and state-controlled enterprises to expected inflation. Directors noted that, in the absence of wage moderation, there was a serious risk that the expected recovery of aggregate demand would be followed by a marked rise in inflation, necessitating once again a monetary squeeze to reestablish price stability ahead of EU accession. Some Directors saw possible scope for the use of catch-up clauses as a way to lower the rate of wage settlements, although some risks in this approach were also noted.

Directors urged the authorities to address the structural weaknesses in the public finances in order to ensure stability over the medium term. They stressed that, while the budget for 2000 should take account of the economic prospects for that year, it should also be cast within a comprehensive medium-term fiscal strategy to reduce the structural deficit. Directors noted that such a strategy was needed not only as part of the EU accession process, but also for purely fiscal reasons. They saw an urgent need to address mounting pressures from mandatory expenditure programs; to minimize the risks associated with the large stock of contingent liabilities and bank and enterprise restructuring costs; and to accommodate needs for additional expenditures, including on the environment and infrastructure. Given these factors, the medium-term fiscal outlook was quite worrisome. Corrective measures should include reform of the tax system, for instance, by broadening the coverage of the value-added tax and harmonizing the rates around the highest one; containment of subsidies to enterprises and other transfers; and reform of the pension system through raising retirement ages and modifying other parameters to ensure its long-term viability.

Directors urged the authorities to accelerate restructuring and privatization in the banking and enterprise sectors, and welcomed the announcement of the timetable for selling the remaining state-controlled banks and a plan for restructuring the enterprise sector. Directors noted the importance of accelerated divestment of strategic nonfinancial enterprises and of the state's remaining stakes in many smaller companies. Directors considered that the enterprise revitalization plan should be targeted to a limited number of enterprises with good prospects for long-term viability. However, they saw this initiative as only one of the needed measures, and stressed the need for the agency responsible for the revitalization plan to be fully independent, and for the plan to be implemented as envisaged. Directors emphasized that the government should refrain from providing additional subsidies to the enterprise sector. Some Directors stressed the fundamental need not merely to change the ownership of financial institutions and enterprises, but to raise their efficiency and competition, while others stressed the vital contribution of small- and medium-sized enterprises established by the private sector. Directors also stressed the need to support bank privatization with an additional strengthening of the regulatory and supervisory environment, including in the capital market area.

Directors noted that the restructuring of the enterprise and banking sectors also required speeding up the preparation of an effective foreclosure and bankruptcy system. More generally, they observed that far-reaching reforms to the legal and institutional framework and improved enforcement of existing laws regulating economic activity were indispensable to ensure proper business incentives and to provide an attractive environment for continued foreign investment.

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

3. MAURITANIA—ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the request from Mauritania for arrangements under the Enhanced Structural Adjustment Arrangement Facility (EBS/99/120, 7/9/99; and Cor. 1, 7/19/99). They also had before them a policy framework paper for Mauritania for the period 1999–2002 (EBD/99/85, 7/12/99).

The staff representative from the African Department said that a mission that visited Mauritania in late June 1999 had verified that nine of the ten prior actions had been fully implemented. In order to comply with the tenth prior action—the removal of all remaining restrictions on payments or transfers on current external transactions—the authorities had prepared draft circulars, which were subsequently examined by the staff to ensure their appropriateness and then issued by the central bank of Mauritania in early July. With those steps, the authorities had effectively completed the implementation of all agreed prior actions under the program. Furthermore, on July 19, 1999, the country's central bank governor had sent a letter to the Managing Director stating that Mauritania was ready to accept the obligations of Article VIII, sections 2, 3, and 4. A staff paper to that effect would be issued to the Board shortly.

Mr. Barro Chambrier submitted the following statement:

The Mauritanian economy achieved impressive results during the past decade, and particularly under the recently concluded three-year ESAF-supported program arrangement that expired on July 1998. Under a series of comprehensive medium-term adjustment programs, savings and growth rates improved, inflation declined to single-digit levels, fiscal consolidation was achieved, and the external current account deficit (excluding official transfers) narrowed. Progress was also made in the areas of price liberalization, restructuring of the banking system and key public enterprises, and tax and trade reforms were introduced. In addition, economic adjustment was accompanied by improvement in social indicators and poverty reduction. While progress was less visible in some areas of structural reforms, important improvement in the regulatory framework, sectoral policies and trade reform were achieved. My authorities remain fully committed to the adjustment process and will continue to address existing weaknesses in the context of the proposed new three-year ESAF-supported program.

In early 1998, the macroeconomic situation deteriorated to some extent, mainly on account of weak performances in the fisheries and iron ore sectors, but real GDP growth attained nonetheless 3.5 percent, above the population growth, and the average annual inflation rate was contained at 8 percent.

In the fiscal area, progress was achieved, despite the crisis that affected performances of the fisheries and iron ore sectors, and the occurrence of some expenditure overruns. However, the authorities reacted quickly to address these shortcomings, their efforts resulting in an overall government fiscal surplus of 2.1 percent of GDP, with total government revenue increasing to 27.2 percent in 1998 up from 26.9 percent of GDP in 1997. This revenue performance was mainly owing to the increase in domestic tax (namely VAT) stemming from diversification of the tax base away from international trade, and improvement in tax administration. Total expenditures increased from 22.7 percent of GDP in 1997 to 25.1 percent in 1998 reflecting the negative impact of the exchange rate depreciation, higher interest payments on public debt and higher capital expenditure, but were kept in close check.

During 1998, broad money grew by 4.1 percent and gross official reserves were preserved at a comfortable level close to five months of import cover, virtually the same as in 1997. Net domestic assets declined sharply as the disbursement of the EU fisheries royalties to the government were sterilized and credit to the private sector attained about 7 percent.

Regarding the external sector the Mauritanian economy was severely affected by exogenous factors triggered by the Asian crisis, particularly on exports of fish products that fell by a further (23 percent), combined with the negative effect of the decline in volume and export prices of high value species, resulting in the widening of the external current account deficit (excluding official transfers) to 11.4 percent of GDP. Despite these developments, Mauritania was able to remain basically current on its external debt service obligations vis-à-vis its multilateral creditors.

Structural reforms were accelerated and deepened, including the restructuring of Air Mauritania, the adoption by the government of a public enterprise reform strategy and of a new fishery sector strategy, the introduction of measures to liberalize the transportation and insurance sectors. Steps to improve the functioning of the foreign exchange market, preparatory works for future privatization of OPT and the energy wing of SONELEC, were taken. Finally, the third phase of the tariff reform, and a reduction in the surrender requirement for SNIM's repatriated export earnings were implemented as scheduled in January 1999.

In light of these achievements and taking account of the necessity to tackle the remaining impediments to growth, my authorities believe that the present medium-term program will enable them to consolidate the gains achieved in the past in reducing financial imbalances, accelerate the reform process, and reduce poverty. Based on the encouraging results achieved in 1998–99, the economic program for 1999–2002, in support of which the Fund assistance is requested, seeks to achieve an average real GDP growth rate of 4.5 percent, maintain inflation at about 3 percent and reduce the external current account deficit to about 10 percent of GDP by 2002.

In view of the recovery in the fisheries sector and higher volumes of iron ore production in early 1999, my authorities are confident that economic and financial prospects will improve. Therefore, consistent with the medium-term objectives, it is projected that real GDP will increase to about 4.1 percent during the 1999 program. The external current account deficit (excluding official transfers) will improve slightly, narrowing to about 11 percent, while the level of gross international reserves will increase to about five months of imports cover of goods and non-factor services. Inflation is expected to decline to 4 percent.

It is worth noting that the strategy envisaged by the government focusing on consolidating and improving macroeconomic stability (including the implementation of an effective and comprehensive program of social expenditure in preparation for the HIPC Initiative), will depend heavily on the rational and gradual decline of budget surpluses to increase spending in social sectors and infrastructure, but also on the resolution of the heavy debt burden, in order to reach higher growth rates than those envisaged under the current program.

Fiscal policy contemplated in the medium-term program will focus on increasing public sector savings by expanding the tax base, while reducing the tax burden on enterprises. These actions will be paralleled with the reduction of the scope of exemptions, and continued reforms of the tax system and a strengthening of tax administration. As regards revenue measures, the main actions will aim at the unification of the VAT rates starting in 2001, and the revision of special tariff schemes. Other actions will target the elimination of special exemption regimes and an overhaul of the direct taxation system.

These policies will be supplemented by a better monitoring and control over expenditure. However, to reach its objectives of expanding private sector roles in the economy and accommodate improvement in the infrastructure and increases in public investment and social expenditure, total government outlays and net lending is expected to increase to 26 percent of GDP in 1999 and remain virtually stable at about 25 percent of GDP in 2000–02. These increases in 1999 would mainly be on account of the recapitalization of Air Mauritania (the airline company), additional investment in the social sectors, basic infrastructure and higher foreign interest payments. No wage increases are budgeted for 1999 and recruitment in the civil service will be limited to the priority education and health sectors, while some room will be allowed for capital expenditure.

As regards monetary policy and financial sector reform, the Central Bank of Mauritania (CBM) will pursue prudent monetary policy in order to consolidate the gains attained in the past with regards to inflation and balance of payments objectives. In this context, my authorities are committed to encourage measures that would lower interest rates and boost private sector investment. My authorities are particularly attentive to deepen financial intermediation. In that vein, the soundness of the banking system and competition will be further encouraged during the program period, by strengthening the structural reforms and measures already introduced in this area.

The external current account deficit is projected to remain unchanged over the program period, as the recovery in fish export volume will be partially offset by the fall in prices of iron ore. Particularly pivotal to the success of the medium-term program is the effectiveness of the exchange market. Thus, to strengthen the external position of Mauritania, my authorities are committed to further liberalize the exchange and trade systems, and intend to increase by steps the amount and retention period of non-mineral export proceeds remaining at the disposal of exporters, and reduce gradually the surrender requirement on SNIM's repatriated exports proceeds. In addition, over the medium term the authorities are committed to move quickly to a more market-oriented exchange rate policy along the line of the March 1999 MAE technical assistance mission.

The Mauritanian economy remains highly vulnerable to external shocks, continues to face an unsustainable debt burden, and is heavily dependent on concessional assistance. Nevertheless, the authorities are determined to remain current on their outstanding external obligations and prevent the emergence of new arrears. Thus, some foreign arrears' payments accumulated in 1998 as well as short-term commercial obligations are expected to be regularized in the context the forthcoming rescheduling agreement. Consistent with these goals, my authorities intend to request a new rescheduling from the Paris Club on similar terms to the last rescheduling, and to seek debt relief from non-Paris Club bilateral creditors on terms at least comparable to those granted by the Paris Club. In addition, they have requested assistance under the enhanced HIPC Initiative in line with the guidelines of the recent Cologne summit.

The authorities are in agreement with the views expressed by the staff on the importance of pursuing and deepening the planned structural reforms through the redefinition of the role of the government, essential to restore private sector confidence. Consistent with these objectives, the authorities plan to accelerate the public sector reform by privatizing a large number of public enterprises in key sectors (transportation, water, electricity), as well as other public enterprises of smaller size operating in various sectors.

Structural reforms will also include measures aimed at creating an enabling environment for private sector development and investment promotion. To that end, the government is committed to promote policies that will improve the functioning of the judiciary system and the overall regulatory environment, while pursuing and deepening the reforms already started in the fiscal and financial sectors, focusing on the further liberalization of the foreign exchange market and trade. Also, the operations of the guichet unique, the one stop window for investors will be improved by reducing the multiple sectoral approvals and registrations. Consistent with policies introduced in the neighboring CFA Franc zone countries and provisions of WTO, the tariff structure will be streamlined including a reduction of the maximum rate. Other structural measures will also be introduced and will apply to the implementation of a modern commerce and arbitration codes. To supplement these measures, key sectors including the fisheries and agriculture (rice) are also targeted for reform in order to improve private sector participation, efficiency and the reduction of government involvement.

My authorities remain concerned by the low quality of social indicators, despite tangible progress achieved in the past. But beyond these measures, and pending the impact of the HIPC Initiative, my authorities intend to continue improving development of human resources and alleviate poverty, through targeted sectoral measures directed at health and education sectors, and employment.

To conclude, I would like to stress my Mauritanian authorities' determination to speed up their efforts to deepen the macroeconomic and structural adjustment, to foster growth, increase per capita income and generate employment. My authorities in view of their good track record, have demonstrated their capacity to implement ambitious agenda of reforms and are confident that they will successfully implement the program package discussed in their memorandum. Thus, they hope to benefit from continued financing under concessional terms, as well as from the advantage provided by the international community under the HIPC Initiative, to supplement their efforts that will result ultimately in improvement in living conditions for the Mauritanian population.

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

Over the past several years the Mauritanian authorities' commendable implementation of a set of comprehensive adjustment programs has yielded significant gains in the form of a much improved macroeconomic environment and better social indicators. In addition to the significant increase in economic growth with declining inflation and the narrowing current account deficit, the authorities were somewhat successful in reducing the incidence of poverty. Also, noteworthy are the fiscal surpluses recorded since 1996. These surpluses are a reflection of the authorities' commitment to strengthen the fiscal position and the macroeconomic stability including by sterilizing a large share of the EU fishing royalties received since 1996.

The welcome improvements in the above-mentioned indicators however should not mask the remaining weaknesses in the economy which the authorities recognize and are committed to address. Of particular significance are vulnerabilities to external shocks associated with the narrow production base as well as the existence of structural rigidities and the lack of a proper regulatory environment which limit the operation of market mechanisms. In this regard, we are encouraged by the authorities comprehensive medium term reform program which focuses on removing the impediments to higher growth and social development. We believe that by building on the macroeconomic gains achieved so far and addressing the unresolved issues identified in Box 1 of the report, Mauritania, with the continued financial assistance of the donor community, can achieve the high rates of economic growth necessary to increase per capita income and reduce poverty further. Here we would encourage the authorities to accord high priority to addressing deficiencies in the operation of the foreign exchange market and preventing future emergence of arrears. Equally, addressing the identified measures to strengthen the still fragile banking sector should not be delayed. We fully support the comprehensive reform agenda mapped out for the next three years under a new ESAF-supported program arrangement. This reform agenda supported by a reduction in debt burden as well as concessional financing will build on the many accomplishments of the past and improve social indicators.

The Mauritanian economy has benefited from the pursuit of strong fiscal consolidation over the past few years and can safely move to a more relaxed fiscal stance especially in light of the need to increase resources for building the infrastructure and for the social sectors. In this regard, the targeted smaller fiscal surplus for 1999 compared with the original projection and the declining trend thereafter appear to be appropriate particularly in view of the expected foreign assistance over the program period. For 1999, we are encouraged by the decision to use part of the windfall revenue from SNIM dividend for non recurrent expenditures. For the medium term, the projected decline in revenue on account of a decline in tariff revenue and the expiration of the Fishery agreement with the EU underscores the importance that needs to be placed on expanding the tax base and strengthening tax administration.

The central bank deserves to be commended for the prudent conduct of monetary policy. For the period ahead, it is important to keep the policy focused on controlling inflation. The development of a repurchase facility to replace the discount window will certainly improve the central bank's ability to more effectively manage liquidity in the short run. On the need to reduce interest rates in the medium term, we are of the view that the impact of lower rates on investment and growth more generally would be magnified if financial sector reforms are undertaken to promote competition in the banking sector and improve the efficiency of intermediation.

The external sector remains vulnerable to exogenous shocks. While we are of the view that expanding the export base is an important long term objective in the efforts to reduce this vulnerability we would like to underscore the importance of promoting the development of fisheries sector and mining industries which together account for over 95 percent of total exports. Weaknesses in these sectors can have potentially damaging effect on the export prospects of Mauritania. Regarding the fisheries sector, we welcome the adoption of the emergency plan and the progress underway to protect this sector and ensure its long-run viability and encourage the authorities to push ahead with the implementation of sound fisheries management measures.

Progress in the domain of structural reform is an essential element in creating the proper conditions for promoting a more active role for the private sector and expanding the production base of the economy. In this regard, the consensus reached in late 1998 on an ambitious reform agenda aimed at withdrawing the government from commercial activity is a major step to this end. We are particularly encouraged by the plans, intended to start in 1999 to privatize Air Mauritanie, the post and telecommunication company, and the electricity services. Removing price controls particularly in the rice sector and liberalizing trade would also be helpful in reducing rigidities in the economy.

Regarding the HIPC Initiative, we look forward to the proposals for strengthening the Initiative and hope to see Mauritania as well as other countries benefit from the potentially enhanced framework. We share the staff's view that the wider review of the HIPC Initiative framework should not penalize Mauritania in terms of identifying the beginning of its track record. We therefore believe that irrespective of the discussion date for the decision point document, the track record for the second stage leading to the completion point should start with the approval of the new ESAF-supported program as agreed during the discussion of the preliminary document for the HIPC Initiative.

With these remarks we wish the authorities every success in achieving the program objectives and encourage them to seek and put to good use technical assistance to aid them in the implementation of the reform agenda.

Mr. Pickford submitted the following statement:

Since 1992, Mauritania has implemented a series of far-reaching macroeconomic and structural reforms. These have met with considerable success in strengthening macroeconomic performance and improving key social indicators in health and education. Nevertheless Mauritania still faces significant challenges, in alleviating poverty and providing a strong base for sustainable economic growth. In this respect, we welcome the ambitious programme of reform proposed for 1999–2002. On the basis of past performance and the strength of the program, we fully support Mauritania's request for a three-year arrangement under the Enhanced Structural Adjustment Facility.

With more than 50 percent living below the poverty line, the key priority must be poverty reduction and improving social conditions. We strongly welcome the authorities' action plan for poverty reduction, and the emphasis in the programme on strengthening health and education provision. Monitoring the impact of the program on poverty and social conditions will be crucial, and we are pleased that the program incorporates key social indicators.

Mauritania's debt burden is substantial. We strongly support the authorities' request for assistance under the HIPC Initiative and, in recognition of Mauritania's strong performance in the past and commitment to ongoing reforms, we believe debt relief under the scheme should be delivered quickly. We have some sympathy with the staff recommendation that the decision point should be delayed until the details of the enhanced HIPC Initiative have been agreed by the Fund and Bank Boards. We can agree to this, provided we can agree: that Mauritania will be in no worse position as a result of the delay; that the track record for the second stage is back-dated to July (as the paper proposes); and that the decision point paper will be discussed by the Boards before the end of October; so that the Paris Club can discuss Mauritania at its November meeting.

Policies to promote sustainable economic growth will be central to achieving long-run poverty reduction. We welcome the program's focus on addressing Mauritania's narrow economic base, and reducing its vulnerability to external shocks. It will be important to consolidate macroeconomic stability, implement the program of fiscal reform, make further progress with export diversification, and open up the economy to much-needed private sector investment. It will also be important for the authorities to address the lack of efficiency in public enterprises, press ahead with their program of privatization, improve governance and transparency, and strengthen the judicial system.

We believe the program for 1999–2002 sets ambitious targets in these areas and that Mauritania has demonstrated the necessary commitment to introduce the wide range of reforms it entails.

Mr. Daïri submitted the following statement:

We thank the staff for a clear and balanced paper. The successful implementation of a series of comprehensive medium-term adjustment programs has significantly improved Mauritania's economy: the growth rate has been increased and sustained; inflation has been reduced to low levels; fiscal position has recorded surpluses of over 2 percent of GDP; and international reserves have reached a comfortable level. Moreover, social indicators have improved markedly, and progress has been made in several structural areas. The private sector's investment and saving have also increased significantly during these years. While the economy faced external shocks in early 1998, the authorities demonstrated a strong commitment to the adjustment program by implementing a set of corrective measures in the second half of the year. As a result of a tight policy stance, inflation was contained to 8 percent in 1998, despite the sharply depreciated nominal exchange rate. However, real GDP growth decelerated largely owing to a weak performance in the fisheries sector and a significant deterioration in the terms of trade. Moreover, the economy remains vulnerable to drought and external shocks.

The outlook for 1999 is more favorable: growth is expected to rebound, inflation is projected to decline to 4 percent, fiscal position will remain strong, and the external current account deficit, excluding official transfers, will slightly improve despite a further 9 percent deterioration in the terms of trade.

The authorities' strong and comprehensive medium-term program for 1999–2002 addresses the main impediments to Mauritania's growth and social development. The strong ownership of the program and the authorities' efforts aimed at consensus-building are among its important features. The authorities have also undertaken substantial prior actions, for which they are to be commended. We concur with the program objectives and policies and support the proposed ESAF-supported program arrangement.

Fiscal policy is to be strengthened through an ambitious tax reform, expenditure control, and improvement in budget procedures. We welcome the prudent easing of the fiscal deficit target that allows undertaking necessary public investment and high quality social expenditures. Greater transparency in the budget, envisaged through incorporating the rice marketing subsidy, is also welcomed. Monetary policy targets are clearly set out in support of the inflation and external objectives, while the exchange rate is accorded the necessary flexibility. Nevertheless, we agree with the staff that interest rates are high for private investment and need to be lowered as inflation becomes more subdued. The key structural issues, namely privatization and market liberalization, particularly in trade, exchange, and price areas, are appropriately addressed. Moreover, the authorities have presented a clear agenda for improving the environment for private sector investment. We welcome the authorities' intention to reform the fisheries and rice sector, as indicated in Mr. Barro Chambrier's helpful statement, and encourage them to speed up the process. Implementation of the planned reforms could greatly boost private sector activity. The program also provides a detailed action plan for poverty reduction and social sector improvement. We welcome the indicators for monitoring progress in achieving the targets in these areas, as explained in Box 3.

We agree with the staff that the reform agenda is extensive and complex. While we are concerned about the government's institutional and administrative capacity to implement the ambitious reform program, we concur with the staff that adequate and timely external financial assistance, at concessional terms, and technical support by the Bank and Fund and other donors are essential for the success of the program. We reiterate our support for achieving an early decision point for Mauritania's eligibility to debt relief under the HIPC Initiative. For reasons already explained in the staff paper, we agree that the decision point should be defined after the Board of the Fund and the Bank have made their decisions on the modifications to the HIPC Initiative framework. However, like the staff, we strongly support the view that the track record for the second stage should commence on the date of approval of the new ESAF-supported program arrangement.

Mr. Barro Chambrier, extending his remarks, thanked Directors for their statements. The Mauritanian authorities should be commended for taking strong prior actions. He could confirm that they had accepted the obligations of Article VIII, as the staff had indicated. It was important to take fully into account the country's track record. The authorities expected that the decision point would start with the approval of the new ESAF-supported program, as agreed during the Board's discussion of the preliminary document for the HIPC Initiative.

The authorities had agreed to publish the detailed policy framework paper but not the letter of intent (LOI), because of the sensitive information that it contained with regard to the exchange market, Mr. Barro Chambrier stated. While it was important to publish LOIs in most circumstances, trade-offs had to be made when there were sensitive issues in order to avoid the proliferation of side letters.

The staff representative from the Policy Development and Review Department said that the staff commended the authorities' decision to publish the detailed policy framework paper, but regretted the decision not to publish the LOI. The staff had worked closely with the authorities and urged them to publish the LOI, under the presumption that all LOIs should be published. However, there had been a trade-off, as Mr. Barro Chambrier had mentioned. The staff had considered putting one or two sensitive points in a side letter, which would have allowed the authorities to publish the LOI. However, given the Board's views on side letters, it had been decided not to have a side letter, and as a result, the entire LOI would not be published. There had been a possibility of publishing the LOI without the two or three sensitive sentences, although that would have set an undesirable precedent. Moreover, the policy framework paper also referred, albeit somewhat elliptically, to those sensitive issues. Perhaps the next time the issue of side letters came up. Directors could keep the case of Mauritania in mind.

Mr. Daïri said that the Board should not state that it was regrettable that the authorities had decided not to publish the LOI. The Fund's policy was that there was a presumption of publication, but authorities could come to the Board to explain why they did not want to publish an LOI. That was the authorities' right, and the Mauritanians had exercised it. Mr. Barro Chambrier's explanations were convincing, in that the LOI contained market-sensitive information. The staff representative's point was correct that the Board did not want multiple side letters and truncated LOIs.

Mr. Askari-Rankouhi wondered which market-sensitive sentences in the LOI the authorities were concerned about.

The staff representative from the African Department said that the authorities were concerned about a sentence in the LOI saying that they stood ready to make adjustments to the exchange rate in 1999, if necessary. Given the depreciation in 1998, the need for a large devaluation in July 1998, and the fact that the public associated each Fund mission with a devaluation, that sentence could cause people to believe that there would be some measures that would require a devaluation. The policy framework paper did not include that sentence, although it did contain the general thrust of the exchange rate policy. Furthermore, the authorities were concerned about the reference to the removal of some tax exemptions in 2000 in the LOI. That issue was politically sensitive, as the authorities wanted to build domestic support for such measures, and there also could be some speculative imports if people knew that those exemptions were about to be removed. The staff had decided that it was much better to have an LOI without a side letter including all of those issues.

Mr. Sobel regretted that the authorities had decided not to publish the LOI. The Board's discussion about side letters had involved the fact that the information that would go into side letters was market-sensitive. However, the staff had indicated that in the case of Mauritania, the information in the second sentence was not market-sensitive but politically sensitive. The first sentence had said that the authorities would "make adjustments as necessary," which also did not appear to be controversial.

The staff representative from the African Department said that the staff's position was to recommend the publication of the LOI to the authorities, in the new spirit of transparency and given that there was such a detailed policy framework paper, which essentially contained most of the same information. The staff, however, recognized the reasons for the authorities' reluctance, and it was hoped that the authorities would publish the LOI in the future.

The Acting Chairman remarked that the concept of market-sensitiveness was related to the issue of the PIN. Side letters could involve politically sensitive issues, such as had been encountered in the case of Thailand, which had gone beyond market sensitivity.

Mr. Barro Chambrier said that it was important to view the authorities' decision not to publish the LOI in the context of the reform underway in the exchange rate market and the need to promote a functioning market. The authorities had been ready to publish the LOI. The point with regard to the removal of the tax exemptions could have been considered in a side letter, but the authorities had accepted that as part of the LOI. The Board should take into account the authorities' willingness to publish the policy framework paper. The authorities would likely be ready to publish the LOI on the next occasion.

Mr. Belay made the following statement:

> Mauritania's economic performance in recent years has been remarkable. Growth since 1995, has, on average, been above 4.3 percent—thus allowing sizeable gains in real page capita income; and inflation has been on a downward path except in 1998 when there was a resurgence of price pressures accompanying currency depreciation. Moreover, the strong efforts at fiscal consolidation have produced a shift in the overall budget balance, from a deficit in 1995 to a sizeable surplus since 1996. The external current account balance has continued to improve although it was difficult for the authorities to keep the same tempo in 1998 because of the weak performance of the fisheries sector. Progress was also made in the area of price liberalization, restructuring of the banking system and key public enterprises and the reform of tax and trade systems. Thanks to all these positive economic developments, Mauritania has

been successful in generating improvements in social indicators and poverty alleviation.

The combination of encouraging economic successes achieved so far and the major challenges ahead suggest that the appropriate strategy at this juncture is one which sets out to consolidate past gains, while looking ahead to deepening the reforms. In this regard, the economic and financial objectives for the medium term and the program for 1999 hold much promise. Mauritania's request for a new three-year arrangement under the ESAF-supported program, therefore, deserves strong support. We are confident, that based on their good track record of policy implementation and commitment to reform, the authorities will successfully accomplish their economic and financial objectives.

For many years to come, Mauritania will continue to be heavily dependent on iron ore and the fisheries sector. This necessarily implies that the country will be vulnerable to adverse changes in the export markets, as well as to unfavorable developments within Mauritania itself such as those associated with the 1997–98 crises in the fisheries sector, suggesting that the policy agenda for the medium term should be for Mauritania to strive for a more diversified economy. In this regard, we are encouraged to note the recent steps to develop nontraditional exports such as stones and marble and plaster, as well as tourism. We would therefore, appreciate the staff's view on the opportunity that exists for these exports to continue to grow as important contributors to the economy.

Commitment to fiscal discipline since 1996 has contributed to macroeconomic stability. However, the level of investment in Mauritania will need to be raised to ensure sustained high growth in real per capita income. In this regard, given the strong overall budgetary position, we share the staff's view that there is a need for gradual relaxation of the fiscal policy stance for the period ahead. However, in view of the strong commitment to fiscal prudence demonstrated over the past three years and the pressing need to finance the much needed investment outlays, we wonder if the lowering of the fiscal surplus could not have started as early as 1999.

Mauritania is on its way to benefit from the assistance under the HIPC Initiative. In this connection, the staff's proposal to postpone the presentation of a final HIPC Initiative decision point document for Mauritania until the Board has made its decision on the perceived changes to the HIPC Initiative framework seems to be reasonable. We also share the staff's view that this delay should not affect the date of commencement of the second stage which ought to coincide with the date of approval of the request for the new ESAF-supported program arrangement now being considered.

With these remarks, we wish the authorities success in their adjustment efforts.

Mr. Al-Turki made the following statement:

Mauritania provides a good example of the progress that could be achieved through sustained implementation of adjustment and reform. Indeed, the Mauritanian authorities' commendable efforts have resulted in impressive achievements. Inflation has been contained, and the fiscal and external payments positions strengthened. Moreover, progress in structural reforms led to reduced distortions and enhanced efficiency.

Notwithstanding the success so far, the economy remains fragile and vulnerable to external shocks. In particular, the dependence on external resources remains high and productivity continues to be impeded by a number of structural rigidities. Thus I fully support the request for an ESAF-supported program as it provides the appropriate framework to consolidate past gains and advance the reform process. While the proposed program is ambitious, Mauritania's well-established track record bodes well for its success.

The emphasis of the program on creating a macroeconomic environment conducive to private sector growth should facilitate efficiency gains and set the stage for sustainable development. In this connection, I endorse the planned increase in capital spending and social expenditure in order to develop the human capital and physical infrastructure necessary for sustained growth. While a gradual decline in the fiscal surplus to achieve these objectives is appropriate, the authorities should not allow the surplus to shift into a deficit over the long run. To this end, implementing the agreed tax reforms is a priority.

Progress in deepening financial intermediation should facilitate a reduction in interest rates, enhance the intermediation process, and encourage private sector investments. In this regard, I welcome the efforts to strengthen reliance on indirect monetary instruments. I am also encouraged by the strengthening of banking supervision and its extension to non-bank financial institutions.

On the external sector, additional measures to improve the exchange and trade system are needed to enhance efficiency and promote growth. Here, I welcome the proposed reduction in surrender requirements on some export proceeds as well as the authorities' stated intention to eliminate remaining restrictions on current transactions and accept the obligations of Article VIII by end-July. In this regard, I welcome the remarks by the staff and Mr. Barro Chambrier at the beginning of today's discussion. It is essential, meanwhile, to regularize financial relations with all creditors. The commitment to enhance efforts in this area is a step in the right direction.

Attaining sustainable private sector led growth also depends crucially on restructuring public enterprises. Full implementation of the program's ambitious agenda in this area will go a long way toward this end. I can endorse the planned reform of the rural sector with help from the World Bank. In addition, the importance of streamlining the regulatory and legal structures to enhance private investment cannot be overemphasized.

Turning to the HIPC Initiative, I can agree with the staff's proposal to defer the presentation to the Board of a final HIPC Initiative decision point document for Mauritania until after the changes in the HIPC Initiative framework have been agreed upon. The track record for the second stage leading to the completion point for Mauritania should commence as of today.

With these remarks, I wish the authorities further success.

Mr. Jourcin made the following statement:

As I have no difficulty to support this new three-year ESAF-supported program arrangement for Mauritania, I will try to be brief. Overall, in the framework of successive programs supported by the Fund, Mauritania's macroeconomic performance has markedly strengthened and a wide range of reforms have been undertaken. The emphasis on the education and health sectors has allowed for a net improvement in social indicators, and the decline in poverty is clearly under way in Mauritania.

Such progress is encouraging, but must be consolidated. In this regard, the new ESAF-supported program constitutes an appropriate and well designed framework. Its macroeconomic assumptions and objectives are realistic, taking into account the external vulnerability of the Mauritanian economy. On the structural front, the program is rightly front-loaded with key reforms, that is also consistent with the request for assistance under the HIPC Initiative. Furthermore, the program incorporates substantial efforts on infrastructure rehabilitation and social expenditures, in line with the suitable redirection of public resources to education, health and poverty reduction. As well, I am pleased with next steps for the gradual liberalization of the foreign exchange market and the ongoing trade reform, notably the harmonization with the West African Economic and Monetary Union's tariff structure.

Turning now to debt issues, I can go along with the staff proposal that the final HIPC Initiative decision point document be considered at a later date under the enhanced HIPC Initiative and, in this case, that the track record for the second stage leading to the completion point begin with today's approval of

> the new ESAF-supported program arrangement. In this prospect, the Paris Club will wait until the decision point to undertake discussions on Mauritanian debt. On this agenda issue, I agree with Mr. Pickford's comments in his statement. I hope that the Paris Club can discuss Mauritania at its November meeting and even, if possible, at its October meeting. Regarding non-Paris Club creditors, they will have to do their part of the effort and to provide debt relief on terms at least comparable to those granted by the Paris Club. I note that some "passive debt" creditors now wish that their claims be considered as active and that this will increase the external debt service obligations during the period ahead.
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> With these comments, I approve the proposed decision and wish the authorities a successful implementation of the program.

Mr. Daïri said that he supported the staff's proposal to postpone consideration of the decision point until after changes were made in the HIPC Initiative framework. However, as even countries that had already reached the decision point or completion points under the HIPC Initiative would be eligible for any improvements in the HIPC Initiative framework, perhaps it would make sense to take the decision on Mauritania and allow a reconsideration in the future. Otherwise, would the Board postpone all decision points until after the expected modifications? What would happen if there was no quick agreement on such changes?

The staff representative from the Policy Development and Review Department said that the staff had addressed Mr. Daïri's point in its proposal. Mauritania was probably the only case that would fall into the transition period between the existing and the proposed enhanced HIPC Initiative framework. The staff had decided not to come to the Board with a complete set of calculations and then revise them two months later, which would have required considerable duplication in a short space of time without additional benefit for Mauritania. The primary objective was to ensure that Mauritania did not lose out in the delay, and there was no reason to believe that it would.

Mr. Harinowo made the following statement:

> The Mauritanian economy has seen marked improvement in recent years, reflecting the authorities' commitment to implement a set of sound macroeconomic policies. This improvement helped the authorities to weather economic difficulties in 1998, which enabled them to post an adequate economic growth outlook at a slower pace, with low inflation, and to record a fiscal surplus. The outlook for 1999 appears brighter, especially with improvements in the fisheries and iron ore mining activities. Despite the better economic situation, however, the economy remains susceptible to shocks, given its heavy reliance on a few export products as well as the region's uncertain weather conditions. We support the proposed decision, as the ESAF-supported program will help further growth and alleviate poverty. We also support an early decision point of Mauritania's eligibility for debt relief under the HIPC

Initiative. We broadly share the appraisal of the staff and would like to make a few comments for emphasis.

While the importance of fiscal consolidation can hardly be overemphasized, we are of the view that the reduction in the fiscal surplus will be necessary for spending in key social sectors. However, equally essential is the implementation of tax reforms to broaden the tax base and establish a more efficient tax administration. To a large extent, the success of the authorities' efforts to uplift the social conditions hinges on their budgetary means, the way resources are spent, and their ability to generate growth. Therefore, structural measures to further enhance the role of the market and the development of the private sector should be expedited. We welcome in this regard the steps taken by the authorities to improve the functioning of the foreign exchange market and to privatize several state companies, as mentioned in Mr. Barro Chambrier's statement. On that issue, it is interesting to note that restructuring was done for Air Mauritania in 1998 and is expected to continue in 1999 through further measures, such as the rationalization of networks and routes. Actions such as this will improve the prospects for the company. An action plan has also been developed for privatizing the company by 2000 with the help of privatization consultants. While I support the effort to restructure the company before privatizing it, in order to arrive at the best possible price, I wonder whether the recapitalization of the company at $600 million in 1999 will finally be able to create privatization proceeds large enough to recover that money. Is there any indication of the value added expected from the privatization of Air Mauritania?

We are encouraged by the authorities' intention to maintain prudent monetary policy. We trust that the authorities will be cautious in lowering interest rates, until the authorities can be more certain of Mauritania's recovery. We support the authorities' plan to closely watch the financial health of the banking system and develop the central bank's supervisory capacities with the Fund's assistance.

We commend the authorities for the significant progress made in trade liberalization and their plan to lower the external tariff further in 2000. Nevertheless, we would encourage the authorities to make further efforts to diversify the export base, so as to increase the resilience of the economy in the face of external trade shocks. With these remarks, we wish the authorities success in their reform efforts.

Mr. Daïri said that he was uncomfortable with the idea of the sterilization of the contribution from the European Union with respect to the fisheries agreement. The staff had indicated that that had happened because the fishery was a natural resource. However, even nonrenewable resources such as oil were typically included in revenue items in almost all countries in the world, thus, why would the authorities have to sterilize the license fee from the European Union?

Furthermore, there had been a major effect on the financing of the budget, Mr. Daïri pointed out. Whereas the staff paper indicated that there was a public debt of 11 or 12 percent of GDP, the table included a footnote saying that, taking into account the deposits of the central bank of the government with the banking sector, the debt was in fact negative. Why not show in the table that the debt was negative instead of positive?

While the treasury held large deposits with the banking system, it had to borrow and to issue paper even though it did not need the money, Mr. Daïri continued. The treasury was issuing those bills, according to the staff paper, to absorb liquidity. However, it was not the treasury's responsibility to absorb liquidity; such costs should be borne by the accounts of the monetary authorities, not added to the budget to increase the cost of the domestic debt. The treasury did not appear to earn any revenue from its deposits, which in turn raised interest rates and crowded out the private sector. Furthermore, at the same time that the treasury paper was issued, bank reserves were declining. What was the relationship between those two trends? Was there no alternative way to absorb excess liquidity, if there was excess liquidity? With the decline in the rate of broad money and of credit to the private sector, the monetary program appeared extremely tight, which could impede the growth of the private sector at a time when the stated goal was to strengthen it.

Could the staff comment on the reference in the LOI that Mauritanians were holding more foreign currency, Mr. Daïri requested. There did not appear to be any figures available on that issue.

The issue of unemployment also did not appear to be addressed in the staff paper, Mr. Daïri remarked. The unemployment situation appeared to be extremely severe, with about 26 percent unemployment in urban areas. Could the staff give some clear information on the size and the evolution of unemployment and what was being done to reduce it? Improving the overall economic climate was one way to address the problem, but perhaps some specific measures geared at reducing unemployment were warranted.

Did the reference to the fact that all export taxes were to be eliminated, except in the fishery sector, include the 10 percent export tax on iron ore, Mr. Daïri asked. That tax was apparently an important item in the budget; what would be the cost of such a measure?

Furthermore, Mauritania had been presented as a success case in bank restructuring because it that had gone through a severe banking crisis and succeeded, Mr. Daïri commented. However, had the fragility of the banking sector indicated in the staff paper been appropriately addressed? Were the measures being envisaged strong enough to prevent the recurrence of the banking crisis that the system had experienced one decade previously?

The staff representative from the African Department said that the program would address the issue of export growth first by setting the preconditions for such growth, through measures developed by private sector activity, and then by ensuring that there was an appropriate exchange rate. Fairly ambitious growth rates for exports were targeted, albeit from a low base, doubling in 1999 and increasing 20 to 30 percent thereafter. The staff believed that there was potential for growth in nontraditional exports, particularly in agricultural exports and in tourism, where revenue was projected to more than double from $4 million in 1998 to more than $11 million in 2002. There had also recently been some growth in exports of plaster and ornamental stones, particularly diamonds and gold. It was hoped that other products would develop through the measures taken in the context of the program, but the staff could not prejudge Mauritania's areas of comparative advantage.

Regarding the fiscal stance and why it had not been loosened, 1998 had been a year of crisis, and severe fiscal slippages in the first half of the year had to be corrected in the second half in order to restore confidence and bolster the declining exchange rate, the staff representative explained. It was considered that after such a precedent, perhaps it was not appropriate to perform a great loosening in 1999. High-quality expenditures also had to be identified. It was always possible to spend money; the issue was spending it in the right way, which the staff was trying to encourage by identifying potential social expenditures. Moreover, there had been some loosening of the fiscal stance, although the numbers looked remarkably the same, because of the windfall gain in dividends, which the staff had allowed to be used for some one-off expenditures, such as road construction. Transparency had also been increased by incorporating rice subsidies into the budget.

There were a number of uncertainties in the medium term, which was why the staff had recommended starting off with a prudent base and then trying to incorporate high-quality expenditures, the staff representative continued. Revenue would be lost through the tariff reform, and there was a question about how the European Union agreement would be renewed, what conditions would be imposed and how many licenses there would be. Changes were planned to make up for any potential loss of revenue. As a result of the uncertainties, the targets for 2000 were more clear than those for 2002 and 2003. On the expenditure side, most of the reduction in the projections for the program could be explained by the decrease in interest payments over the program period. Social expenditures for the medium term were expected to increase considerably. Expenditures on education were 5.2 percent of GDP in 1999 but would rise to 5.7 percent by the end of the program. Spending on health, 1.6 percent of GDP in 1999, would rise to 2.4 percent by the end of the program. Expenditures on the fight against poverty, 1.5 percent of GDP in 1999, would be 2.3 percent by the end of the program. Overall there would be an increase from 8.6 to 10.3 percent of GDP in social expenditures and the fight against poverty. However, once the revenue situation was more clear and further high-quality expenditures could be identified, there could be even more spending. A country like Mauritania should be spending more money, but it should spend it appropriately.

The staff did not expect much revenue from the privatization of Air Mauritania, the staff representative commented. Air Mauritania had been experiencing major financial losses, and there was an investment bank in charge of conducting the privatization, finding the right bids, and setting the correct price. It was not known what the price would be, but it could be low. However, the staff was not seeking to maximize the revenues from the sale; instead, the object of the privatization was to stop financial losses, improve efficiency, and change the role of the government.

The sterilization of the contribution from the European Union with respect to the fisheries agreement was a choice that the authorities had made, the staff representative noted. The fishery had been considered to be a resource that could not be depleted, yet it had been substantially depleted in the previous two years. In the shocks suffered in 1997 and 1998 there had been a decline of almost 50 percent. The authorities had been trying to manage it well, although it would significantly affect the financing of the budget in the future.

In 1999, the authorities, despite the tight monetary targets, had left room for an increase of credit to the private sector of 23 percent, the staff representative reported. That should be adequate to let the private sector develop in Mauritania. The greatest concern was whether there would be enough high-quality demand for such credit. Moreover, a tight monetary stance was related to the issue of dollarization. The staff did not have firm data on the dollarization in Mauritania, although there was a strong presumption, from anecdotal evidence, that there was such a foreign exchange market. The foreign exchange liberalization measures were designed to encourage cash and foreign exchange transactions. Steps were being taken in the program to help bring back some of that money to the market, for instance allowing the retention of the export proceeds or allowing domestic residents to have foreign exchange accounts. Much of the parallel market had been driven by the need to obtain money for traveling. With the exception of the acceptance of Article VIII and the liberalization of current account transactions, it was expected that some of that parallel market would disappear.

The staff had been puzzled by the increasing velocity of credit growth in recent years, the staff representative continued. The program could only reflect what was prudent; thus, if there had been an increase, that had to be taken into account when setting targets. That velocity had allowed for adequate room for credit growth to be given to the private sector, so it had not been entirely negative. The staff was not planning for it to continue at such a rapid pace in the future. There were also other issues that would come into account regarding the financing of the budget. For example, although not much revenue was expected from the privatization of Air Mauritania, there could be considerable revenue from other privatizations. The staff had not incorporated that into the medium term, but it could give further room for private sector credit growth.

The issue of the treasury bills was as a matter of definition, the staff representative explained. There was a stock of treasury bills in the deposits of the government with the banking system. It was correct to say that those deposits were the treasury bills. The staff was not trying to hide anything but had presented both pieces of information. The treasury bill market was not only raising financing or controlling liquidity, it was a benchmark interest rate and a way to develop monetary policy through monetary instruments.

Mr. Daïri asked whether the deposits in the central bank were remunerated.

The staff representative from the African Department said that the deposits at the central bank were believed to be remunerated and the deposits of the commercial banks definitely were.

One measure in the program to be carried out in 1999, the introduction of the repo facility, which would give the central bank a much better way of controlling liquidity, would satisfy one of Mr. Daïri's concerns, the staff representative reported.

The data available on unemployment was not reliable, the staff representative observed. The staff had reported one figure—that there was 26 percent unemployment in urban areas. There were also figures including and excluding nomads, which were presented in a study conducted in 1996, although the data was not considered to be good enough. The staff knew that unemployment was a severe problem, but the only way to address it in the program was to encourage the private sector to generate employment. The public sector was already overstaffed and could not generate employment. Public sector employment growth would be limited to the health and education sectors, and the other sectors would remain set on a net basis. It was hoped that the measures intended to promote private sector investment and activity would also generate employment. There were some employment creation programs in the context of the fight against poverty and poverty alleviation, although the authorities were being careful to avoid setting up work creation programs, which would not be a permanent solution to poverty. They wanted to educate, train, and create activity that would be self-sustaining, not set up programs that would make the people depend on continuous handouts from the government.

Mr. Barro Chambrier said that the authorities understood the need to achieve higher growth rates and address the problem of unemployment, as did other countries in the region and elsewhere. Among the programs designed to reduce unemployment was a vocational training program. The authorities were also making efforts with regard to labor-intensive work, with assistance from the World Bank, and there were projects in the fisheries and agricultural sector.

Regarding Mr. Daïri's question on the tight monetary policy, in order to avoid a dollarization, there must be confidence in the local currency of the country, Mr. Barro Chambrier commented. In 1998 the real effective exchange rate had depreciated by 16.8 percent, and there had been an inflation rate of 8 percent. That needed to be taken into account. The authorities were also trying to encourage indirect instruments, which was a beginning. It was hoped that the authorities would be able to achieve their objective in terms of inflation as well as their external objective.

Mr. Daïri said that while it was important to have confidence in the currency, a lack of confidence in the banking system would promote dollarization. That was why he had asked whether the actions envisaged in the banking sector were strong enough to avoid a recurrence of the crisis, and had asked for clarification of the exemptions on export taxes.

The staff representative from the African Department noted that the 10 percent tax on iron ore was a sales tax and thus was not affected by the program measure.

There were sufficient measures in the program to address the issue of the banking sector fragility, the staff representative remarked. The commercial banks in Mauritania had improved; liquidity ratios had been mostly satisfactory, and several banks were already in a fairly good position. The staff was closely following one bank that had been in a continuously weak position. There were also reforms envisaged in terms of privatizing the housing bank. Fragility in the banking sector was a serious concern, because the previous banking crisis was one of the reasons why there were such large spreads between deposit and lending rates. An increase in competition and improvements in the health of the banking system were the only way to reduce those spreads. Deposit rates were about 10 to 14 percent, the treasury bill rate was 16 to 17 percent, and yet lending rates could be 28 to 33 percent, which could deeply affect investment. The more important factor in terms of that spread was the health of the banking sector. The measures to improve banking supervision that had been implemented were being followed. Technical assistance in the field in that regard was adequate. Measures to approve new banks and improve competition were also expected to help. Two major banks were in talks with foreign partners, which would also be a good development for the Mauritanian banking system, bringing financing and capital as well as know-how and new technologies to the sector.

Mr. Luo made the following statement:

At the outset, I would like to thank the staff for providing us a set of well-written papers and Mr. Barro Chambrier's helpful statement. I would also like to commend the authorities for their impressive achievements under the economic adjustment programs of recent years. It is encouraging that macroeconomic stability has been strengthened and a comprehensive structural reform program has been placed as a priority on the agenda.

As I broadly agree with the staff appraisal, I will limit myself to a few areas for comments.

On the fiscal front, the authorities have adopted tight demand management policies in recent years which resulted in an overall government fiscal surplus of 2.1 percent of GDP in 1998, and probably 2.2 percent of GDP in 1999. After several years of fiscal consolidation, I could support the staff's assessment that a cautious decline in the fiscal surplus in the coming years may be appropriate, owing to the need to boost economic growth and conduct social reform.

On the monetary and external fronts, as Mauritania is a highly open economy and faces the vulnerability of external shocks, I could see some merit in the authorities' current policy of a managed float. It is encouraging that the authorities have intended to further liberalize the foreign exchange market and have tried to be consistent with the obligations of Article VIII, nevertheless, a well-sequenced pace should be taken in this field.

In terms of the HIPC Initiative, I share the view of Mr. Shaalan and Mr. Bakhache as expressed in their preliminary statement that soon Mauritania and other HIPC Initiative countries should hopefully benefit from the potentially-enhanced framework.

Owing to the well-prepared medium-term economic program, the substantial prior actions taken by the authorities, and Mauritania's excellent record of payments to the Fund in the past, I can support the authorities' request for a new three-year arrangement under the ESAF-supported program.

With this remarks, I wish the authorities every success in the future.

Mr. González-Sánchez made the following statement:

I would like to congratulate the Mauritanian authorities for the comprehensive medium-term adjustment programs adopted in the last decade. These programs have delivered good results in some important areas. Nevertheless, weaknesses persist in the economy, which the authorities intend to deal with in the context of a three-year arrangement under the ESAF-supported program.

I support the proposed decision, given the good economic results achieved so far, the excellent record of payment to the Fund, and the need to address remaining weaknesses. I agree in general terms with the staff's appraisal, and would only make some comments for emphasis.

The fiscal surplus is projected to decline from 2.2 percent of GDP in 1999 to 0.4 percent of GDP in 2002. As Mr. Shaalan and other Directors, I concur with the staff that a cautious decline in the surplus is warranted, given the need to accommodate the increases in both public investment and social expenditures. In this context, and given that more than 50 percent of the Mauritanian population lives below the poverty line, I welcome the focus on poverty reduction and the development of human capital.

In his informative statement, Mr. Barro Chambrier correctly indicates that consolidating and improving macroeconomic activity will depend substantially on the gradual and rational decline of budget surpluses in order to increase both public investment and social spending, but also on the resolution of the heavy debt burden. In that connection, I support the authorities' intention to obtain assistance under the HIPC Initiative. I agree with the staff that the decision point for the country should be delayed until the modifications to the HIPC Initiative framework are defined, albeit without penalizing the country, thus initiating the track record for the second stage on the date of approval of the new ESAF-supported program arrangement.

The elimination of the remaining exchange rate restrictions conducive to the acceptance of the obligations of the Article VIII is encouraging. The intention to implement measures to further liberalize the trade sector, including the limitation of the maximum tariff rate, of the maximum import tariff rate to 20 percent is also appropriate. Could the staff provide information about the level of the average import tariff rate in Mauritania?

I agree with the staff that one of the main impediments to growth in Mauritania is its narrow economic base, especially for exports. Adverse exogenous shocks and a poor diversification of exports have contributed to maintain a high external current account deficit, excluding official transfers. Although considerable progress has been achieved to reduce this deficit, the current level of 11.4 percent of GDP is still high, and the projections envisaged in the program for the coming years placing the deficit close to 10 percent of GDP for 2003 implies substantial vulnerability of the Mauritanian economy to exogenous shocks. The economy also faces an unsustainable debt burden and is heavily dependent on concessional assistance. I encourage the authorities to place special importance on the correction of these weaknesses.

Finally, I urge the Fund to be ready to provide the technical assistance that might be required to reinforce the program, and wish the Mauritanian authorities all the best in their efforts.

Mr. Jacoby made the following statement:

Despite Mauritania's macroeconomic problems at the beginning of 1998, prompt actions by the authorities have improved the overall economic situation. Inflation has been contained, the public finances remain fundamentally sound, and GDP growth has regained its former pace. However, there is no room for complacency: the economy is still vulnerable to external shocks, unemployment is still high, and poverty remains widespread. The authorities must not slacken their efforts to advance the structural reform process.

As I generally agree with the staff's appraisal, I can be brief.

As a first step toward developing an environment propitious to private sector investments, the diversification of Mauritania's economy has a high priority. The drive to restructure the public sector must be continued and broadened to improve the present poor allocation of scarce economic resources. No effort should be spared to make the judicial system more efficient and more transparent. I also welcome the measures taken so far to restructure the system of taxes and tariffs to eliminate exemptions, and I urge the authorities to continue.

A sound, well organized banking sector is the backbone of an economy. I therefore applaud the authorities' desire to strengthen the regulatory framework and improve banking supervision. The staff is right in pointing out that further steps are needed to increase the competitiveness of the financial sector.

As to the HIPC Initiative, I can accept the staff's view that the decision point document for Mauritania should be discussed at a later date, and that the track record for the second stage should start with the new ESAF-supported program arrangement.

Finally, Mr. Chairman, I support Mauritania's request for a new ESAF-supported program arrangement and I wish the authorities every success in implementing their ambitious adjustment and reform program.

Mr. Harada made the following statement:

I commend the authorities for their continued progress in reducing inflation, improving the fiscal balance, and increasing international reserves under ESAF-supported programs over the past several years. Unfortunately, however, I must mention here that most of the end-March and end-June quantitative benchmarks were not met as a result of the slowdown in the economy, which was triggered by the sharp deterioration in the performance of the fisheries and iron ore sectors since 1997. This is evidence of the economy's high dependence on these sectors. This small basket of domestic industries fluctuates easily and falls into a vicious-circle situation. In this case, the decline in exports had a negative impact on economic growth and the current account balance, causing a higher price for imports and domestic inflation. This is a matter for concern. I would, therefore, stress the importance of diversifying the productive base in the medium term.

In this connection, it is encouraging that the authorities have decided to develop private sector activities through privatization of key public sectors, such as electricity and telecommunications. Moreover, reform of the judicial and regulatory frameworks for private sector activities would strengthen investment incentives. In addition to these fundamental steps aimed at economic growth, the authorities should also target specific industries for development in order to diversify production over the medium term. I would appreciate the staff's comments on which sector, apart from fisheries and mining, could be targeted.

On the fiscal front, the current account deficit was minus 11.4 percent of GDP in 1998, a sharp fall from 1997, although there has been improvement in export performance and an absence of marked pressure on the central bank's official reserves. As the staff stated, without diversification of production, economic uncertainties such as a decline in the fisheries sector or a drop in the price of iron ore represent a significant downside risk to the economy. I therefore strongly hope the authorities will be flexible in adjusting the exchange rate level and take a tight macroeconomic stance.

In this context, I appreciate fiscal consolidation. As a background for private investment, it is necessary to increase expenditure on primary education and health care and to reduce poverty. As a decline in tariffs because of increased international trade liberalization will exert downward pressure on revenue, it will be difficult to maintain fiscal consolidation over the next few years; I therefore hope the authorities will make every effort to reduce low priority expenditures and strengthen tax revenue through tax reform by seeking an efficient tax system and reducing tax evasion.

Finally, a few words about the staff's proposal on the decision point for the HIPC Initiative and the track record for the completion point. According to this proposal, the decision point would be set after the change in the HIPC Initiative framework in the fall, whereas the track record would start when the ESAF-supported program is admitted. However, the arguments about track record for the completion point, including its term, should be made at the decision point. At present, therefore, I do not think it is necessary to decide the start of the track record for the completion point.

With these comments, I support the staff's appraisal.

Mr. Sobel made the following statement:

We would like to thank the staff for a well-written set of papers. Mr. Barro Chambrier opened by mentioning Mauritania's strong track record, and, as he says, Mauritania in recent years has performed quite well on the macroeconomic front with the support of the Fund, notwithstanding the adverse circumstances that the economy faces. The authorities deserve considerable praise for their efforts. We would only underscore a few points.

The ultimate measure of performance is whether the reforms can translate into benefits for all of Mauritania's people. Despite the considerable progress made, real per capita income this decade has been rising at a modest 1.5 percent per annum, which remains the staff's outlook for the coming years. And, as Mr. Daïri and the staff observed, unemployment is seriously high. Against this background, we agree with the staff that Mauritania needs to build on its macroeconomic successes and intensify its efforts to liberalize the economy, reduce the role of the state, strengthen the legal framework, and bolster social policy.

On the fiscal front, like Mr. Harinowo, we echo the staff recommendation that the role of indirect taxation should be strengthened and that tax and tariff exemptions should be dismantled, not only for the sake of efficiency but also to combat rent-seeking behavior. We commend the authorities for their efforts on trade liberalization, and look forward to the implementation of the fourth stage of liberalization.

We welcome the prospective acceptance of Article VIII. We also welcome the progress that has been made to liberalize the foreign exchange market. We note that this issue remains on the table, even though we are into the fourth consecutive ESAF-supported program for Mauritania. Thus, I would say in response to a remark from Mr. Lou that the time framework for four ESAF-supported programs probably has allowed for an adequate period of well-paced sequencing. We hope that the staff will continue to bear down on this matter with the authorities so that the subject can disappear from future discussions.

Could the staff add a few words about the role of SNIM in the economy and clarify the plans for the reform of SNIM? Is privatization of this firm contemplated? I was not sure how to interpret paragraph 43 of the staff report. Furthermore, why will SNIM only be subject to common law regarding the VAT in 2001, and is the staff satisfied with the overall tax contribution of SNIM?

We welcome the report's heavy focus on improving social conditions and fighting poverty. I appreciated the figures cited earlier by the staff and the efforts to raise social spending, and agree with the staff's statement that Mauritania—and indeed any country—should spend the money correctly. Continued collaboration between the Fund and the World Bank would be central in this regard.

We support the view that the fiscal surplus should be modestly reduced to support social spending, and hope that the benefits of the HIPC Initiative relief can be linked more explicitly to increased social spending. Like Mr. Jourcin and others, we can support delaying the consideration of the final HIPC Initiative decision point until after the discussion on the changes in the HIPC Initiative framework have been taken.

The staff representative from the African Department said that the unweighted average import tariff in 1998 was 19 percent. The authorities were committed to implementing the fourth phase of the tariff reform in the beginning of 2000, with a maximum tariff of 20 percent, in line with the West African Economic and Monetary Union (WAEMU), thus the average tariff would fall in 2000. There was no data for 1999.

Regarding whether the government would target specific industries, the approach of the program was to create the conditions for private sector development and to reduce favoritism, the staff representative explained. Favorable treatment and specific endowments or preferences had, in the experience of other countries, not worked well, and tended to result in a loss of fiscal revenue, rent-seeking behavior, and generally counterproductive results.

The staff was not advocating an industrial policy for Mauritania, the staff representative remarked. There were certain sectors that looked promising, specifically construction, tourism, and new activities in agriculture. The liberalization and privatization of telecommunications had made rapid growth in certain sectors feasible. The staff's approach, however, was to set the conditions for private sector development, not to direct where such development should be.

The SNIM had an important role in the economy, the staff representative noted, accounting for a good share of exports and about 14 percent of GDP. No privatization of SNIM was contemplated. SNIM was already partly private, in the sense that some of its shareholders were foreign investors, with the majority of the shares belonging to the Mauritanian government. The government did not have any intention, at least in the foreseeable future, to privatize the company, which was nationalized several years previously. The main reason for that given by the authorities was the key role of SNIM, in the sense that it basically had the monopoly on key natural resources, which accounted also for a large share of the country's foreign exchange earnings. Giving such power to the private sector was not something that the Mauritanian authorities were prepared to envisage for the time being. However, there was a possibility that they would open up to more private sector participation and perhaps the quoting of SNIM in the foreign exchange market.

The tax contribution of the SNIM, as stated in Footnote 16 in the staff report, was regulated by a convention agreed to by SNIM and the government of Mauritania, the staff representative continued. A 20-year convention had been signed in 1979, and it had been renewed for another 20 years starting January 1, 1999. According to that convention, the SNIM was exempt from all direct and indirect tax fees and royalties concerning activities related to water and mining. There was a 10 percent sales tax on the value of mining exports and a lump sum tax payment of UM 80 for staff benefits. There was also a value-added tax (VAT) payment on domestic purchases, which was also a lump sum tax, and tax payments on imported goods sold domestically without transformation for the use of SNIM staff. The new element in the revised convention was the adoption of that lump sum payment for VAT. That was in line with the custom in other mining companies, not only in Africa but in other countries such as Canada. If SNIM was subject to the normal mining code, the revenue that would accrue to the Mauritanian government would be less than under the convention. Nevertheless, the staff had been troubled by some aspects of the new convention, for example the fact that the lump sum VAT payment would apply for 20 years. Something that was appropriate today would not necessarily be appropriate in 20 years' time, so the staff was concerned about the loss in tax revenue for the government. The staff was also concerned about the implications for competition, because the SNIM had a number of subsidiaries that were subject to common tax law. It was easy to import goods with exemptions for the parent company and then have those goods transferred to the subsidiary companies. That was considered a loophole for further loss of tax revenue. There was also a possibility that those companies were in growing sectors like tourism or the production of cut stone, which would tilt the playing field in favor of those subsidiaries, narrowing the sectors where the staff expected a growth in private sector activities. That was why the staff had targeted that particular aspect of the convention.

The authorities in 2000 were committed to going back to the common tax law for all VAT transactions related to SNIM, which would involve drawing up a limited list of goods exempted from VAT and would be strictly related to mining activities, the staff representative continued. The Fiscal Affairs Department (FAD) would provide technical assistance to make sure that the final convention was appropriate. That had been the staff's main concern when it had examined the convention. The staff would continue to monitor the situation, and if further modifications were considered necessary, the staff would suggest them and follow up with the authorities. The main concern of the FAD technical assistance mission in the field when the program had been negotiated was possible tax evasion and the distortion of competition.

Mr. Sobel asked whether, while the authorities did not intend to privatize SNIM, the staff was satisfied with that public enterprise's reform strategy.

The staff representative from the African Department said that the staff was satisfied with what the authorities were planning to do vis-à-vis SNIM and would follow up with the actual implementation. The question was whether the authorities implemented the measures that they were committed to implementing. The staff did not consider that there would be a particular gain in efficiency if the company were privatized. It was a profitable company run under commercial conditions. The fact that there were foreign shareholders and that the company's accounts were controlled by external auditors gave the staff confidence that it was well-run—and perhaps the most profitable public company in Mauritania. From that point of view, the staff was not insisting that the company be privatized, although it should be run efficiently and transparently, with no loss of revenue to the budget, and no distortions in the economy from its activities.

Mr. Barro Chambrier made the following concluding statement:

> The staff has provided candid and comprehensive answers to Directors' questions and the discussion was constructive, as usual.
>
> The U.S. chair pointed to the fact that this is the fourth consecutive ESAF-supported program in Mauritania. That is true, but it shows that development is a long process, and it is important to have in mind the country's resource constraints and administrative capacity. Mauritania's track record

speaks for itself. The authorities will continue to implement forcefully the ambitious reform agenda in the memorandum.

The most important issue, given the still high level of poverty, is to accelerate structural reforms to increase the growth rate. I will convey Directors' views on the need to improve the functioning of the foreign exchange system, to be sure that the banking system is in good health and to accelerate privatization. All of these actions should help to diminish the vulnerability of the economy to exogenous shocks.

I would like to emphasize that the far-reaching measures that have already been implemented over the past decade, despite some internal resistance and an often adverse external environment, have produced some fruit. Nonetheless, my authorities will persevere in their efforts. As noted by most Directors, the challenges still lie ahead, particularly regarding poverty alleviation.

In this regard, I would like to draw Directors' attention to the measures that the authorities intend to take, particularly in the fiscal area. Adequate provision for current and capital spending in the social sectors and infrastructure would lead to a gradual decline in the fiscal surplus over the medium term. However, these efforts alone will not be sufficient. Thus, I would like to thank Directors for their understanding and support of the authorities' request for continuous and adequate levels of external concessional financing.

In this context, I welcome the fact that Mauritania will reach an early decision point for eligibility under the HIPC Initiative—as soon as the modalities guiding the initiative are agreed upon by the Fund and Bank Board—without being penalized as regards their good track record for the second stage. I wish also to indicate that an important structural reform agenda will be implemented in the exchange system and the financial sector and to promote the development of the private sector. Regarding the important point emphasized by Mr. Daïri on the unemployment problem, the authorities are aware that measures will not bear fruit immediately, as is the case for many other countries, but are determined to continuously maintain the adjustment momentum.

I thank Directors for their support of Mauritania's request for a new three-year ESAF-supported program arrangement, as well as for their useful comments, which I will convey to the authorities. I would like also to join the authorities in expressing our appreciation to the staff team for the support and advice given in the context of their adjustment efforts.

The Executive Board took the following decision:

1. The government of Mauritania has requested a three-year arrangement under the Enhanced Structural Adjustment Facility in an amount equivalent to SDR 42.49 million.

2. The Fund notes the Policy Framework Paper for Mauritania set forth in EBD/99/85.

3. The Fund approves the arrangement set forth in EBS/99/120.

Decision No. 12012-(99/78), adopted
July 21, 1999

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between E.M./99/77 (7/16/99) and EBM/99/78 (7/21/99).

4. INCOME POSITION FOR FY 1999—REVIEW

The Fund has reviewed the income position for FY 1999 in accordance with Rule I-6(4)(c). (EBS/99/127, 7/14/99)

Decision No. 12013-(99/78), adopted
July 19, 1999

5. ELEVENTH GENERAL REVIEW OF QUOTAS—PERIOD FOR CONSENT TO INCREASES—EXTENSION

Pursuant to Paragraph 4 of the Resolution of the Board of Governors No. 53-2, "Increase in Quotas of Fund Members—Eleventh General Review," the Executive Board decides that notices of consent from members to increases in their quotas must be received in the Fund before 6:00 p.m., Washington time, on January 31, 2000. (EBD/99/84, 7/12/99)

Decision No. 12014-(99/78), adopted
July 16, 1999

6. KOSOVO—TECHNICAL ASSISTANCE

The Executive Board authorizes the Managing Director to approve the provision of technical services to Kosovo consistent with the terms of Resolution No. 1244 (June 10, 1999) and other relevant decisions of the UN Security Council. (EBD/99/80, 7/7/99)

Adopted July 16, 1999

7. ANNUAL REPORT, 1999—TRANSMITTAL TO BOARD OF GOVERNORS

The Executive Board approves the transmittal of the 1999 Annual Report to the Board of Governors under cover of the letter set forth in EBD/99/92 (7/16/99).

Adopted July 20, 1999

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by an Advisor to an Executive Director, and by Assistants to Executive Directors as set forth in EBAM/99/101 (7/15/99) is approved.

APPROVAL: May 4, 2001

SHAILENDRA J. ANJARIA
Secretary