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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 98/104

10:00 a.m., September 25, 1998

Contents

Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, Acting Chairman
S. Sugisaki, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	S.M. Al-Turki
	M. Askari-Rankouhi, Temporary
T.A. Bernes	W. Szczuka
R.F. Cippà	R.J. Singh, Temporary
B. Esdar	W.-D. Donecker
E.R. Grilli	J. Spraos
	A. Giustiniani, Temporary
D.Z. Guti	J.P. de Morais
	O.-P. Lehmussaari
	M. Vismantas, Temporary
	M. Carlens, Temporary
	O.L. Bernal, Temporary
	J. Prader
	B.S. Newman
	S.D. Melese-d'Hospital, Temporary
	R. Fernandez
	S. Le Gal, Temporary
	M. Daïri
	L. Palei, Temporary
	J. Shields
A.S. Shaalan	M.H. Elhage
M.R. Sivaraman	
G.F. Taylor	O. Kwon
	J. Guzmán-Calafell
J. de Beaufort Wijnholds	Y.G. Yakusha
	A. Barro Chambrier
	H. Ono
	S. Hinata, Temporary
Zamani, A.G.	C. Harinowo
	Wang X., Temporary
A.G. Zoccali	N. Eyzaguirre
	J.A. Costa, Temporary

R.H. Munzberg, Secretary
A. Linde, Acting Secretary
J. Prust, Acting Secretary
N.M. Hairfield, Assistant
S. Soromenho-Ramos, Assistant
S.W. Tenney, Assistant

Initiative for Heavily Indebted Poor Countries—Implementation—Draft Report to Interim Committee; and ESAF and HIPC Initiatives—Financing Status—Report of Managing Director to Interim Committee
Staff representatives: Leddy, PDR; Boote, PDR

Bulgaria—Extended Arrangement
Staff representatives: McGuirk, EU1; M. Allen, PDR

Indonesia—Review Under Extended Arrangement
Staff representatives: Neiss, APD; Burton, PDR; Lipschitz, PDR; Hagan, LEG; Peters, IBRD

Also Present
IBRD: S. Gooptu and R.K. Peters, East Asia and Pacific Regional Office; E. Somensatto, Europe and Central Asia Regional Office; A. van Trotsenburg, Africa Regional Office. African Department: E.A. Calamitsis, Director; A. Basu, Deputy Director. Asia and Pacific Department: H. Neiss, Director; A. Singh, Deputy Director; W.S. Tseng, Deputy Director; C.M. Browne, R.A. Djaafara, K.H. Lee, S. Nolan, S.E. Oppers, European I Department: M.C. Deppler, Director; Y. Horiguchi, Deputy Director; L.D. Everaert, N.T. Feyzioglu, B. Horvath, A.K. McGuirk. External Relations Department: R. Brauning, V. Shastry. Fiscal Affairs Department: M. Cangiano, J. Escolano, P.R. Gerson. Legal Department: W.E. Holder, Deputy General Counsel; R.C. Baban, H. Elizalde, S. Hagan, R.L. Weeks. Middle Eastern Department: D. Burton. Monetary and Exchange Affairs Department: A. Ize. Policy Development and Review Department: J.T. Boorman, Director; M. Allen, Deputy Director; T. Leddy, Deputy Director; A.R. Boote, A.J. Doughty, N.L. Happe, K.H. Kang, G.R. Kincaid, L.J. Lipschitz, A.T. MacArthur, A.G. Santos. Research Department: E. Detragiache. Secretary's Department: S. Bhatia, J. Prust, B.A. Sarr. Treasurer's Department: D.Williams, Treasurer; W.J. Byrne, J.C. Corr, H. Flinch, C.A. Hatch, D.M. Hicks, S.T. Lurie, P.R. Menon. Office of the Managing Director: M. Cross, Personal Assistant; J.A.P. Clément, O.J. Evans, H.L. Mendis. Advisors to Executive Directors: W.F. Abdelati, T. Brizuela, C.M. Gonzalez, E.J.P. Houtman, N. Jadhav, H. Mori, S. N'guiamba, Y. Patel, O. Sein, M.R. Shojaeddini, M. Sobel, F. Zurbrügg. Assistants to Executive Directors: A.S. Alosaimi, T. Belay, J.G. Borpujari, K.S. Brownlee, M. Budington, J. Chelsky, D. Chen, H.W. Cocker, D. Fujii, K. Gobe, N.K. Gueorguiev, M.R. Hajian, J.K. Honeyfield, C. Josz, A. Kapteyn, K. Kask, S.K. Keshava, T.-M. Kudiwu, A. Lucenti, J. Mafararikwa, F. Mercusa, D. Merino, W. Merz, J. Nelmes, M. Nemli, J.L. Pascual, Qi J., J.N. Santos, C-P. Schollmeier, Vongthieres O., S. Vtyurina, P. Winje.

1. INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES — IMPLEMENTATION—DRAFT REPORT TO INTERIM COMMITTEE; AND ESAF AND HIPC INITIATIVES—FINANCING STATUS—REPORT OF MANAGING DIRECTOR TO INTERIM COMMITTEE

The Executive Directors considered the draft report, prepared jointly by the staffs of the Fund and the World Bank, on the implementation of the HIPC initiative (EBS/98/166, 9/23/98; Rev. 1, 9/25/98), together with the Managing Director's report on the financing status of the ESAF and HIPC initiatives (EBS/98/167, 9/23/98; Rev. 1, 9/25/98).

Mr. Esdar stated that, while he had some comments on the joint report, he would refrain from asking for changes, in the spirit of compromise.

Mr. Daïri suggested that the report be revised with regard to some points, to better reflect the language of the summing up of the recent meeting on the HIPC Initiative.

The Chairman said that the language would be reviewed.

Mr. Pickford pointed out that the language of paragraph 4, on the need for an urgent discussion of the long-term financing needs of the ESAF-HIPC trust, was slightly different from the language used in the report on the status of financing, which said that it was essential that the decisions necessary to complete the financing efforts be taken by the end of this year.

The Chairman said that the consistency between the two reports would be established.

Mr. Fernandez asked that the comments on Bolivia in the paper be made consistent with those in the report that had been discussed in the Board the previous week.

The Chairman said that the staff would make changes along those lines.

Mr. Daïri remarked that, since the report would be published, it might be useful to indicate in the section on country implementation why there would be only one decision point and one completion point until May, to avoid the disappointment of readers.

The Chairman said that language would be introduced to explain why the process was not as speedy as would be desirable.

Mr. Esdar suggested that, to accommodate Mr. Pickford, the language used in the summing up on the issue on the financing, which stated that Directors "stressed the need for urgent decisions in this area to address the long-term financing needs," would be appropriate.

The Chairman confirmed that every effort would be made to assure consistency with the summing ups.

Mr. Newman asked the staff to also check whether the paragraphs on interim financing in the report were consistent with the summing ups.

Mr. Esdar observed that, in the report on financing, it was noted in the second paragraph that there was an urgent need for additional borrowing of 1 .2 billion. He had never seen that figure before and, before the report was circulated to the ministers, he would have liked a chance to discuss it. At the very least, it should be noted that that figure was a preliminary estimate.

The Chairman said that that change would be made.

Mr. Esdar asked when the final discussions on the report of the financial architecture and capital markets would be.

The Chairman replied that he would be reviewing the next version of the paper with the staff that morning, and he hoped that it might be possible to circulate it by the end of the day.

Mr. Grilli asked the Chairman to confirm that the Board would have an opportunity to discuss the estimates in the financing paper in the near future.

The Chairman said that the paper would be discussed after the annual meetings.

Mr. Newman asked the staff about the status of pledges that had been made but which had not yet been confirmed. He had noted that the paper seemed to assume that they were forthcoming.

The Chairman replied that many pledges needed, in fact, to be firmed up, and that he would be using the occasion of the Annual Meetings to press national delegations to confirm their commitments. In concluding, he noted that the drafts of both papers would be reviewed and re-submitted to the Board for a final look. They would then be sent to the Interim Committee.

2. BULGARIA—EXTENDED ARRANGEMENT

The Executive Directors considered a staff paper on Bulgaria's request for an Extended Arrangement in an amount equivalent to SDR 627.62 million, together with the authorities' letter of intent (EBS/98/162, 9/11/98; Sup. 1, 9/14/98; Sup. 1, Cor. 1, 9/24/98).

The staff representative from the European I Deparment submitted the following statement:

> Since the staff report for the request for Extended Arrangement (EBS/98/162, Supplement 1) was issued, the authorities have completed all but one of the prior actions as envisaged originally. They have made progress in the implementation of the remaining one which relates to the removal of existing tax preferences from the Foreign Investment Act (FIA) and the submission of the legislative changes regarding the tax treatment of investment to Parliament (EBS/98/162, Supplement 1, page 28, Box 3, Item 1). The delay is for technical reasons and stems from the need—for both the authorities and the staff—to make a comprehensive assessment of changes regarding the tax treatment of investment recently proposed by the World Bank's Foreign Investment Advisory Service (FIAS). The proposed changes to which the authorities are committed would fulfill the understandings reached under the program in this area. These include, inter alia, the elimination of all tax preferences and holidays currently provided in non-tax legislation, and the introduction of a new category of

assets—information technology—for depreciation purposes and an investment tax credit for depressed regions. Also envisaged is a reduction in corporate tax rates to offset the impact of the elimination of existing tax preferences and holidays. The authorities have agreed that the scope and timing of any reduction in corporate tax rates will be determined at the time of the assessment of the fiscal outlook and stance for 1999. All these changes will be introduced as a package of amendments to the tax code and relevant non-tax laws prior to adoption of the 1999 budget. In light of the authorities' continued commitment to implementing this prior action and the planned early review of the budget for 1999, the staff considers that this delay is not jeopardizing the satisfactory implementation of the program.

At a meeting of the G-24 Network on Monday, September 21, participants were informed about the authorities' medium-term economic program and financing needs. Existing commitments from G-24 participants for 1998 were reconfirmed. In this regard, the staff was informed that an understanding has been reached with Spain on an outstanding debt dispute, and that formal signing and ratification of the agreement by the Bulgarian Parliament is scheduled to take place in October. Ratification of this agreement is a condition for the EU to release the second tranche of it's existing balance of payments loan. A G-24 Consultative Group meeting is planned for later in the year or early next year to obtain official commitments for the program beyond 1998, and the confirmation of adequate financing assurances for 1999 will be necessary for completion of the first review of the program.

Recent economic developments have generally been favorable despite the continued turmoil in international markets. In August, consumer prices fell by 0.9 percent while unemployment edged down to 10.8 percent. Domestic financial markets have remained calm, with yields on three-month treasury bills stable at 5.2 percent, even though stripped yields on Bulgarian Brady bonds are still around 20 percent. Despite the much lower than projected inflation, budgetary revenues have been performing well during July and August and the indicative revenue target for end-September appears well within reach. Data confirm that most of the one-off factors affecting the budget favorably during the first half of the year have disappeared and in some cases are being reversed, as anticipated. Expenditures have remained in line with the program. As a result, the overall balance for January-August has remained in surplus and is somewhat larger than programmed.

Policies and prospects remain as indicated in the staff appraisal, and the staff continues to support the authorities' request for an Extended Arrangement from the Fund.

Mr. Wijnholds submitted the following statement:

At the time of the last Board discussion on Bulgaria in May, Directors commended the authorities on the successful completion of the 14-month SBA, characterized by spectacular restoration of macroeconomic stability and significant advancement of the structural reform agenda. They also encouraged the authorities to formulate a comprehensive three-year program with strong structural emphasis that can be supported by an extended arrangement. This has indeed happened and such a program is in front of us now. Let me thank the staff for their great effort in helping the authorities put the program together and preparing it for the Board's consideration today.

Before turning to the program, let me briefly describe the economic developments in 1998 so far. First quarter real GDP was 18 percent higher than a year ago. While this is mostly due to the very low base - the crisis-ridden first quarter of 1997 - it confirms that the rebound in economic activity, which started in the third quarter of 1997 is well under way. Preliminary data point to continued growth in the second quarter, putting the annual target of 5 percent within reach. Inflation was negative three months in a row, bringing the price level roughly to where it was in the beginning of the year. While the negative inflation is due partly to international and seasonal factors, and significant increases in administered prices are planned before end-year, it is likely that the end-1998 inflation will be well below the annual projection of 9 percent. The budget ran a substantial surplus in the first six months and will show balance or a small surplus for the year as a whole. The current account was broadly balanced in January-June, and foreign exchange reserves at end-June exceeded US$2.7 billion, about 5½ months of imports of GNFS. Emerging markets turmoil has not adversely affected confidence or macroeconomic stability so far. All this provides for a favorable macroeconomic environment, which the medium-term program can build upon.

The main goal of the program is ambitious - completing in essence the process of transition by 2001 and preparing the country for starting EU accession talks. This means establishing a competitive market economy, based on predominantly private ownership and modern institutional arrangements, while preserving and strengthening the already achieved macroeconomic stability. The most important policy initiatives are briefly set out below.

Fiscal Policy

Fiscal policy has the difficult task of balancing between maintaining a sustainable position to ensure the viability of the currency board arrangement and providing funds necessary for the deep reforms in major expenditure systems like pensions and health as well as for growth-enhancing infrastructure investment. While the aim is for the overall fiscal position to be broadly balanced, the program provides for a modest deficit of up to 2 percent of GDP for each of the program years to cover transitional costs of expenditure reforms and infrastructure investment needs. Within this framework, a host of fiscal reform measures will be implemented to broaden the tax base, allowing a lowering of some tax rates; strengthen tax collection and start civil service reform. Operations of extrabudgetary funds will be gradually incorporated into the budget, starting with the two biggest funds. A pension reform effort is already under way, sharply reducing the number of people eligible for early retirement and linking benefits to total contributions made to the system since January 1997. During the program period the retirement age will be raised and a three-pillar system will be developed, consisting of mandatory pay-as-you-go and fully-funded components, and a voluntary component through private pension investment funds. The health care reform legislation has already been passed, providing for the start of the contributions to the Health Care Trust Fund from July 1999 and service contracting between it and doctors and hospitals from January 2000. The Public Investment Program is aimed at eliminating bottlenecks and catalyzing private investment in infrastructure. The budgetary cost is about 2.5 percent of GDP per annum. Significant private cofinancing (not only in the form of loans, but also as concessions and joint ventures) is expected for investment in ports, roads and energy facilities.

Financial Sector Reforms

The currency board arrangement will continue to serve as an indispensable framework for maintaining macroeconomic stability and fostering structural reforms. Bank privatization will remain a priority. After selling Post Bank (the third biggest bank in the country) in August, preparatory work is well under way for selling two other major state banks in 1999. It is expected that all state banks, except possibly the State Savings Bank, will be privatized within the duration of the program. Bank supervision and prudential regulation have been strengthened with the introduction of a higher capital requirement and a comprehensive system for overall bank assessment. Voluntary pension funds - a new class of nonbank financial institutions - will be established and subject to stringent investment restrictions to avoid excessive risk-taking in domestic and international investments.

Privatization and Incomes Policy

Privatization is expected to be essentially completed by end-1999, when 70 percent of state fixed assets (based on 1995 accounts) would be divested. The other 30 percent represents infrastructure and other resources where the Constitution preserves state ownership; however, many of them would be divested through concessions. To improve transparency and the speed of the process, reputable foreign consultancy firms have been hired as privatization consultants for all big enterprises. The process of privatization has been slower than expected this year, partly due to waning interest of foreign investors in emerging markets. However, significant preparatory work has been done and a few big firms (the tobacco holding, the telecom company, the biggest bank and the oil refinery) are in the pipeline for privatization in early 1999.

The divestiture and liquidation of the biggest loss-makers continues. There remain 27 enterprises (out of 41 originally) on the list of commercial enterprises isolated from bank credit. About 15 of them have contracts with privatization consultants expiring in the Spring of 1999, so the deadline for their privatization or liquidation has been extended to June 30, 1999. The utilities on the other isolation list will be subject to vigorous restructuring including increases in tariffs to ensure their financial viability and phase out subsidies from the budget.

In order to safeguard the currency board it is important to avoid a loss of competitiveness, particularly through excessive wage growth. While privatization is the ultimate weapon against this, in the interim period wage control over state-owned enterprises (SOEs) is being strengthened. The SOEs will continue to be subject to the existing regulation, whereupon the wage bill can be increased only to the extent of labor productivity increases, and only when the firms are current on all their obligations. Enterprises in violation of the policy are subject to ceilings on their wage bills. It is expected these and other measures to harden budget constraints will foster restructuring and support appropriate real wage growth over the medium term.

Elsewhere in the economy, wages in the budget sphere will be raised by about 20 percent in 1999 as part of civil service reform, making up for some of the ground lost compared to the private sector. The minimum wage will be raised by 25 percent, after its links to many other social transfers are severed.

Sectoral Reforms

After years of delaying much-needed but painful reforms, very ambitious undertakings are envisaged in the energy, agriculture and trade sectors. In the energy sector, the goal is to ensure cost recovery by the end of the program. This entails substantial price hikes over the program period, especially in the tariffs affecting the population: 69 percent for electricity, 103 percent for district heating, 69 percent for coal and 186 percent for briquettes. Nevertheless, the government is committed to these reforms as the only way to improve efficiency, limit subsidies and attract foreign participation and badly needed investment to the sector. Improvements in the social safety net will help to mitigate the painful effects for low-income households. The World Bank is also involved here through an adjustment lending loan.

In agriculture, the main goals are rapid completion of land restitution, including expediting processing of land titles and starting a land market, as well as minimizing government intervention. In the interim, however, the government will provide some lending to the firms in the sector, as land cannot be used as collateral for bank credit yet. The World Bank is playing an active role here, too.

The program envisages a major trade liberalization effort, manifested in lowering the (unweighted) average tariff to 10 percent for nonagricultural goods and 22 percent for agricultural goods by 2001, liberalizing many non-tariff barriers, eliminating almost all export taxes and the import surcharge from January 1999. This will bring the trade regime from a moderately restrictive one to a very liberal one (rating 2 by the Fund's scale of trade restrictiveness). The trade reform is consistent with the EU accession strategy and other regional trade agreements. On January 1, 1999 Bulgaria will become a member of CEFTA and enter into a free trade area with Turkey.

The exchange system is very liberal on current transactions. Today, September 24 the authorities have notified the Fund that they are accepting the obligations under Article VIII, sections 2,3 and 4 of the IMF's Articles of Agreement.

The Macroeconomic Framework and The Risks Ahead

These reforms are expected to result in real GDP growth of 4-5 percent per annum, single-digit annual inflation throughout the period (declining to 5 percent in 2001) and a current account deficit of around 3 percent of GDP in each program year, driven mainly by higher investment demand for renovations of fixed capital and technology in many firms after their privatization. These figures are consistent with preserving macroeconomic stability even in the face of the adverse external environment in part of the region. A higher current account deficit could be compatible with external viability, if private foreign direct investment in the tradable goods sector turn out to be higher than envisaged. However, given the uncertainty in the outlook, the authorities are prepared to adopt more restrictive fiscal policies, if necessary to offset unfavorable current account developments. Financial policies can also play a role in slowing down domestic demand even under a currency board arrangement via changes in reserve requirements and the regime for short-term and portfolio capital flows. The authorities will use all these weapons to prevent the economy from overheating.

The major external risks come from the low world commodity prices and the regional situation. Unfortunately, the loss of export revenues stemming from low steel, copper and fertilizer prices which constitute about 40 percent of the Bulgarian exports is only partially offset by the low energy import bill. The effects of these developments have been taken into account in the staff projections. However, the repercussions of the regional crisis could be worse than expected earlier, and a prolonged deterioration of investor sentiment toward the region could slow down privatization projects and/or lead to lower direct investment. Should these risks materialize, the authorities stand ready to adopt corrective measures as needed.

Mr. Lushin and Ms. Vtyurina submitted the following statement:

Bulgaria's stabilization and reform program supported by the 1997 Stand-by Arrangement has been successfully implemented. The establishment of the CBA and an ambitious structural reform program have generated economic outcomes that are much better than expected. During the first half of 1998 CPI rose by merely 2 percent, and GDP is expected to grow by 5 percent in 1998, following two years of deep recession. The new medium-term program of the authorities is targeted at enhancing the prudence of fiscal policies, improving financial discipline, accelerating the liberalization of markets and achieving higher living standards.

The impressive fiscal performance in the first half of 1998 was helped by one-off factors. In future the authorities will need to undertake a significant effort to arrive at a balanced budget, which is their medium-term commitment. It is, therefore, appropriate that they are prepared to accept a budget deficit of up to 2 percent of GDP if costs of structural reforms appear to be more than projected. However, in order to preserve the stability of the CBA, the authorities should monitor closely the developments in the current account and maintain a flexible management of discretionary expenditures to enable a tightening of the fiscal stance, if this becomes necessary. On the revenue side, we welcome the measures undertaken by the authorities to strengthen tax administration. We agree with the staff that such steps as VAT reduction and elimination of tax exemptions may be expected to improve revenue performance over time. The authorities' objectives designed to improve the adequacy of the social special safety net are welcome, but they should fit the goal of medium-term fiscal sustainability.

Recent unfavorable developments in the neighboring countries are adversely affecting the Bulgarian economy through lower prices on key exports and reduced external demand. The external current account shifted from a large surplus in 1997 to being balanced in 1998 and is projected to show a deficit of about 3 percent of GDP under the new program. It is encouraging that this current account path is supposed to result in only modest financing gaps over the program period, which could be met through official financing. However, the current account position remains vulnerable due to the heavy debt burden. We, therefore, agree with the staff that Bulgaria's susceptibility to unfavorable external developments would require continued vigilance under the EFF-supported arrangement to ensure the implementation of sustainable policies.

A large part of the new program is devoted to structural reforms. We welcome the fact that the authorities are fully aware that the sustainability of the CBA will depend crucially on efforts to strengthen the enterprise and banking sectors. In the privatization area, the previous program's ambitious targets were not fully met. In our view, this is not a major fault. As the government is working on several procedures to speed up the privatization process, investors are taking time to fully evaluate the opportunities. We want to reiterate the position taken by this Chair in previous discussions that it is the quality rather than the speed of privatization that will eventually bring fruitful results. Concerning the banking sector, it is encouraging that the remaining inefficiencies are being addressed toward to the development of a sound banking system. It is essential, however, that under the bankruptcy law the liquidation of the banks, insolvent after the 1997 financial crisis, be conducted at a greater speed to eliminate moral hazard.

In conclusion, we want to underline the obvious commitment of the authorities to continuation of sound economic policies in their new medium-term program. We are sure that this program deserves to be supported by an Extended Arrangement. Therefore, we endorse the proposed decision and wish the Bulgarian authorities success.

Mr. Spraos made the following statement:

Bulgaria's economy has been stabilized in record time, surpassing all expectations. This is quite remarkable. Mr. Wijnholds in his prelininary statement calls it spectacular and I agree.

And it is quite remarkable even though the lowering of the budget deficit from 12.7 percent of GDP in 1996 to roughly zero in 1998 was more than accounted for by a fall in the interest cost of the national debt. The inflation of 1996-97 which decimated the real value of the leva-denominated debt and the subsequent fall in nominal interest rates (associated with the decline of inflation which followed) had a dramatic effect on the interest cost of the debt despite the fact that the leva-denominated debt was no more than 30 percent of the total debt in 1995. I am not pointing to this to belittle the stabilization achievement, which I reiterate is remarkable, but to draw attention to how meaningless it is to attach importance to the overall budget balance when inflation is high.

Stabilization having been attained, what comes next? If you create strong foundations, you should aim at erecting an ambitious construction on them. Are the medium-term growth projections in the staff paper ambitious enough? At a growth rate of 5 percent, it will take Bulgaria eight years just to reach the pre-1990 GDP. Even allowing for the fact that we are not comparing exactly like with like, I would not call it a strong growth target. A certain deficiency of ambition may be present here.

Caution is, of course, important just eighteen months after the hyperinflation episode. And the staff paper has caution in abundance, with recurrent references to the conservativeness of the proposed program's assumptions and to the imbedded safeguards. But at some point caution must start to yield a little to ambition. More ambition, it seems to me, would be warranted after a time, if all goes well in the meantime.

Supply-side reforms can increase the economy's capacity and growth potential, but a balanced expansion of supply and demand is needed to take full advantage of capacity growth. There is more than one way of aiming at this and, from a distance, it borders on the presumptuous to be specific. But, in the particular circumstances of Bulgaria, it may be worth thinking of increasing public investment which, when financed by borrowing, is simultaneously demand- and supply-enhancing. This is an economy that is crying out for improvements in infrastructure. They will yield not only productivity gains but will create additionally a more hospitable environment for both indigenous and foreign investment. It is also an economy which is flush with liquidity, to the point that banks seek foreign assets for their portfolios; and to the point that the interest rate for leva time deposits is negative when deflated by the projected CPI rise for the next twelve months—not just marginally negative, heftily negative. A by-product of this is that the dollarization of the economy—more than 50 percent of bank deposits are foreign currency-denominated—cannot be counteracted through more attractive leva interest rates. A mopping up of liquidity through government borrowing, when monetary policy is constrained by the currency board regime, would therefore have beneficial side-effects: repatriation of capital as liquidity is absorbed and also some dedollarization of the economy, which also implies repatriation of capital.

I therefore welcome the provision for running a deficit of up to 2 percent of GDP for the duration of the program. Or, rather, I welcome it for the first year, when it may be imprudent to go further, not only because we are still close to the hyperinflation episode of early 1997, but also because we are going through a period of severe financial market turbulence. When the latter subsides, however, the matter should be reviewed. If no other sources of faster growth emerge in the meantime and no major new constraints crawl out of the woodwork, a larger government borrowing to finance infrastructural projects should be on the agenda.

Faster growth, when feasible, is not only important because of the benefits that it confers directly but also because it is likely to be the greatest facilitator for Bulgarian admission to the European Union to which it aspires.

As of now there does not appear to be a resource constraint on a more ambitious policy for faster growth nor any inflation-accelerating pressures. The size of the national debt (estimated at 86 percent of GDP in 1998) appears a more substantial constraint at first sight, but less so when one looks at its projected trajectory. With an overall budget deficit of 2 percent a year, the ratio of debt to GDP falls, according to Table 10, by 6-8 percentage points a year in the next three years, thanks presumably to a rapid growth of nominal GDP. A small slowing down of the rate of decline of the debt ratio as a trade-off for higher real GDP growth does not look like a bad bargain. (The benign effects of faster GDP growth on the debt ratio should be borne in mind.)

I turn lastly to the current account constraint. There was a substantial current account surplus in 1997 but it is projected that there will be a deficit of 3 percent in 1999, tapering down to 2 percent in later years. For 1999, and perhaps for one or two years after that, these numbers will have to be adjusted a little upwards to allow for the turmoil in Russia (which has an 8 percent share in Bulgarian exports). But, nevertheless, these numbers are small in relation to most comparable cases and, moreover, FDI projections, which are very conservative, cover well over half the current account deficit in almost every year up to 2004. But even low deficits such as these may, in the present financial climate, represent a limit which is not to be tampered with. In that case, a wider current account deficit that would be associated with faster growth can only be envisaged, as staff say, if FDI turns out higher than expected. But in more settled conditions it would be unusual to view these orders of magnitude as unduly constraining for a country in Bulgaria's phase of economic development, especially when Fund support is added to the equation. Moreover the mopping up of liquidity associated with government borrowing will induce a repatriation of capital, for reasons outlined above, and this will help in the financing of the deficit.

It goes without saying that, should things go wrong, the authorities should be ready to take corrective action. Indeed a more ambitious growth policy can be embarked upon more confidently if there is readiness to do just that.

I support the proposed decision and add the hope that, in later reviews of the program, policies designed to attain more ambitious growth targets will gain prominence in the agenda.

Mr. Shields made the following statement:

Our authorities strongly support this program. We had considerable doubts about the formulation and timing of the previous stand-by arrangement, but were delighted by the remarkable performance of the Bulgarian economy during its implementation. Bulgaria has transformed itself in the past 18 months, from a demonstration of what not to do in transition, to a demonstration of how a strong program can work, and lead to recovery and growth. We hope that Bulgaria can continue to set a strong example to certain countries which may be about to experience the same difficult conditions which Bulgaria faced in early 1997.

The EFF is appropriately ambitious. The structural priorities in the areas of taxation, banking regulation, financial discipline, and privatization are the right ones. Despite the fact that the authorities had been urged to move ahead with structural reforms, progress has not been sufficient, even though structural reforms were largely responsible for Bulgaria's crisis.

Some of the measures contained in the program are likely to be difficult, both technically and politically. However, the Bulgarian authorities have demonstrated, over the period of the stand-by arrangement, that they can take tough decisions. The measures included in the EFF are tougher than those faced by the authorities under the stand-by arrangement, making the EFF program a medium-term proving ground for the Bulgarian economy. If the measures can be successfully implemented, they will mark the beginnings of a prosperous free market economy.

Certainly, the most important and difficult aspect of the program is the reform of the state-owned enterprises, and the banks which are connected to them. The key is enforcing hard budget constraints, and ensuring that this objective is not undermined by quasi-fiscal flows and questionable lending practices. The progress on the banking sector is encouraging, particularly on banking supervision. This is an area where urgency in implementation is needed. To improve the health of the banking system, problem SOEs need to be segmented off from the banking system. The principle area of concern under the stand-by arrangement was the uneven progress that was made on the liquidation of unviable enterprises. The isolation of problem enterprises from the banking system must be fully concluded by the middle of 1999.

With the support of the World Bank and others, there is a chance to carry through with the necessary restructuring plans, including schemes, such as providing severance payments, retraining, and setting up of small businesses. Unfortunately, unemployment in these enterprises is inevitable. Delays will not solve the problem, they will simply prolong the pain and the drain on the rest of the productive economy. The privatization program, as set out in the program, is ambitious. Also, given the current investment climate, the level of expected privatization receipts may be too ambitious. Nevertheless, it is important to focus on the actual objectives of privatization. If carried out properly, the main benefit should come from the recapitalization of enterprises, high productivity, and ultimately, a stronger revenue base for taxation and a contribution to a stronger trade position for the economy. The price, however, is also an issue. In order for the privatization program to be acceptable, one can understand the authorities' reluctance regarding fire sales. There are arguments on both sides about the correct timing, but when it comes to enterprises of little value, they should be sold off as soon as possible. The authorities have to be weary about overestimating the value of enterprises, which reflects previous poor practices, particularly on industrial enterprises. It will be important for the authorities to get the right professional advice from objective investment advisors. The authorities do need to guard against delaying privatization on false hopes of a much better price in the future. If there are good reasons for a delay, then in the intervening period, it is crucial that hard budget constraints be firmly applied.

On other structural issues, I note the references in the staff report to continuing problems on crime and corruption, and the efforts made to reduce these. Given Bulgaria's poor external reputation, it will be important that continued action is taken in these areas.

On tariffs and other types of trade restrictions, it is important that the agenda be carefully maintained.

The macroeconomic policies seem to be appropriate. The currency board is working well, and the prospects for the fiscal accounts to be made consistent are good. Some rather imaginative ideas seem to have been taken to reach the fiscal target in 1998, in light of the good revenue performance. However, it is important that the authorities have contingency plans on both sides of the budget. Finally, we hope that the authorities continue with the success they have established over the past 18 months.

Mr. Prader made the following statement:

I fully share Mr. Shields' praise for the stabilization achievements of the Bulgarian authorities, and welcome the authorities' resolve to consolidate these gains and to establish, through accelerated structural reforms, a solid foundation for sustainable long-term economic growth. Generating and sustaining high economic growth is the main challenge for the authorities in the period ahead. This is crucial, not only from the viewpoint of catching up with its European Union aspirants—as shown in Figure 2 of the staff report—but, more importantly, from the point of view of sustaining public support for the reform. After eight years of an almost uninterrupted economic decline, which reduced real GDP to 60 percent of its 1990 level, the patience of the population to tolerate economic hardship is certainly limited. In order for public support to be sustained, early tangible results, in terms of a general improvement of living standards, are desperately needed. We are pleased that after years of failed experiments, the authorities recognize that the fastest way to achieve this is through difficult reforms.

Accelerating structural reforms will ultimately bring more economic efficiency and more economic growth; however, there are several signs which suggest that the expected recovery might take longer than projected, such as falling industrial sales, slowing retail sales, and stagnant credit to the nongovernment sector. These indicators do not bode well for an early recovery of domestic demand, or for the staff's projection of 5 percent real growth in 1998. These facts, coupled with the impact from the Russian crisis, were probably the main reason why the Bulgarian Prime Minister admitted a few weeks ago that some foreign analysts—including the IMF—had been too optimistic about Bulgaria's prospects for economic growth in 1998. Recently released figures are quite dramatic. The August 1998 figures show that industrial sales and exports have decreased by 15 percent and 25 percent, respectively. Incidentally, the statement by the staff representative only mentions data which have improved in August. Given the latest figures, have the IMF's growth assumptions been correspondingly adjusted? Does the EFF program take the fallout from the Russia crisis fully into account? A downward growth revision may have to be larger than just 1 percentage point. In light of recent developments, the program does not seem ambitious enough, as Mr. Spraos fears in his statement. However, even if it takes eight or nine years to reach the pre-1990 GDP level, Bulgaria's policy experience would suggest caution and patience, rather than impatience. Should growth turn out to be significantly lower than projected, the pressure on the government to provide more stimulus to the economy can be expected to rise.

While we are certainly sympathetic to the government's ambitious planned investment program, it would not seem financially prudent to embark on a massive investment program when the growth prospects are revised downward significantly. The balance of payments effects of such an investment program should also not be underestimated. Moreover, one wonders whether the program's medium-term current account path is somewhat on the optimistic side. It will be important for the authorities not to make the government the main engine of growth. The experience of some other transition countries shows that too much emphasis on public investments can delay the needed restructuring of the enterprise sector. Not only because of the crowding out effect, which would certainly be a binding constraint in light of the recent confidence effects after Russia and given Bulgaria's limited possibilities to raise capital abroad, but also because of the possibility that higher growth at the aggregate level might mask underlying problems at the micro level. The authorities are therefore well advised to ensure that public sector investment will play only a complementary role, while leaving enough space for private sector initiative and risk-bearing investment. In this regard, the fact that nongovernment credit changed slightly during the first half of 1998, despite the government running a surplus and banks having excess liquidity during the same period, may suggest that either the banks are voluntarily refraining from lending activities, or perhaps that the restructuring of the enterprise sector has hardly started. With the authorities' heavy emphasis on an employees' buy-out approach toward privatization, one should expect a surge in demand for credit from the new owners to rehabilitate their plants' obsolete capital. Increasing the productive capacity of plants' must unavoidably happen, and the authorities should be ready to adjust commensurately, especially when the income from privatization turns out to be lower than expected, and the budget surplus disappears.

On privatization, the authorities have already acknowledged that their ambitious program will be negatively affected by the fallout from the continuing political and economic crisis in Russia. While this is a realistic expectation, and investors' bids will certainly be lower, this should not lead to a conclusion that privatization must be put on hold until the sales' conditions improve. Although such concerns are understandable, as they could easily delay the privatization process, the authorities should also see the new opportunities, such as attracting foreign investors. Aside from these reservations about Bulgaria's growth prospects, we fully support the authorities' request for an extended arrangement and wish them all the best.

Mr. Elhage made the following statement:

We would like to commend the staff for the well-written and comprehensive report. As pointed out in the report before us and Mr. Wijnholds helpful statement, Bulgaria has achieved a remarkable turnaround in economic performance after being on the verge of collapse in early 1997. The stabilization and structural reform measures supported by the SBA has contributed to the strengthening of the economy and improved the economic outlook. The request for an Extended Fund Facility signals the authorities' commitment and recognition that the reform effort needs to be continued. This is clearly reflected in the implementation of the prior actions in recent weeks.

Since we are in general agreement with staff assessment and analysis we will limit our comments to fiscal and structural policies. These two areas are particularly important to underpin the Currency Board Arrangement.

On fiscal policy, the emphasis accorded to maintaining an underlying fiscal stance of a broadly balanced budget over the medium term with actual deficit of up to 2 percent of GDP during the program period to accommodate for transitory costs is well placed. The budgetary reform should be centered around lasting reductions in expenditures, in particular in pensions and health systems. In the absence of measures to restrain the growth of pension outlays, the authorities' medium-term fiscal targets might be difficult to achieve. In this event, taxes may have to be increased to accommodate the pressures on expenditures. This may be the second best option and is better avoided. These considerations would underscore the need to contain the growth in pension and other entitlements. In this regard, we welcome the measures listed in paragraph 12 of the LOI to improve the sustainability of the pension system over the medium term and the passage of the health care reform legislation.

Turning to the revenue side, the measures that are being implemented to improve the efficiency of the tax system by broadening the tax base and capturing the growing private sector in the tax net are clearly steps in the right direction. In order to lower the marginal tax rates including the VAT rates over the medium term, a successful implementation of the revenue measures listed in paragraph 9 of the LOI would be needed.

To improve competitiveness which is important for the success of the CBA, a strong privatization program and banking sector reform are needed. The privatization program would make a major contribution to the financing needs of the budget and to improve efficiency in the economy which is needed to move the growth path to a higher level. In this connection, we welcome the authorities' objective to privatize by end-1999 all commercial enterprises, as well as a significant part of the utilities.

The turmoil in the international financial markets and legislative bottlenecks have understandably reduced foreign investors interest in Bulgaria's privatization program and new direct investments. It is in Bulgaria's best interest to continue with structural reform with particular emphasis on strengthening the banking sector, judicial and regulatory reforms. Strengthening these policies should create an environment conducive to the promotion of FDI and donor support. This is particularly important in view of Bulgaria's heavy debt burden.

In conclusion, we encourage the authorities to pursue the agreed agenda diligently. With these remarks we support the proposed decision.

Mr. Hinata made the following statement:

It is encouraging that the Bulgarian economy has recovered from the 1997 financial crisis that resulted from addressing a fiscal disciplined policy under the SBA program, while in 1998 real GDP is expected to grow by 5 percent and hyper-inflation has been reduced to about 10 percent, compared with more than 500 percent at the end of 1997. The fiscal deficit is expected to be balanced owing to the Bulgarian authorities' efforts at addressing structural reform. At the outset, I commend the authorities for strengthening the economy.

However, I am concerned that the current external balance shifted from a surplus in 1997 to a deficit in 1998, and the current external deficit is projected to increase somewhat over the next several years, owing to an expansion of the trade deficit. In addition, while the pace of foreign direct investment has slowed down, according to the staff paper there have been indications of flagging momentum in recent months. It is necessary to further strengthen structural reform in order to promote privatization, to strengthen financial discipline in the enterprise and banking sectors, and to improve agriculture reform with a market-oriented price determination mechanism. Given the increase in the current external deficit in mid-term, it is important to continue firm and consistent macroeconomic management and make an effort to tighten the fiscal stance.

This chair supports the proposed decision. But I would like to make a few comments, for emphasis.

First, on the external front, given the need to tighten the fiscal stance due to a shift in the current account balance to a deficit in 1998, and the staff view that the external environment has become more difficult, including less positive investor sentiment toward emerging markets and economic difficulties in neighboring countries, I would like to stress the necessity of maintaining a disciplined stance on fiscal policy.

Second, regarding fiscal policy, it is encouraging that the authorities are committed to continuing the underlying fiscal position of a balanced budget for the mid-term. As Mr. Spraos welcomed in his statement, I share the staff's view that it is necessary to ensure an actual deficit of up to 2 percent of GDP to cover the transitional costs of structural reforms and higher infrastructure investment. I, therefore, think fiscal policy should be managed to ensure sufficient revenue. In this context, it is important to finalize fiscal reforms early, including reform of pensions and health systems, strengthening tax revenue through strengthening tax administration and improvement of the expenditure control system.

Third, on structural reform, it is necessary to improve productivity and to strengthen external competitiveness for mid-term sustained economic growth. An acceleration of privatization in the state-owned enterprises and banks, and a strengthening of the banking system and banking supervision should be addressed. With the prospect of the current external account deficit expanding, sufficient capital inflows through foreign direct investment are crucial to restoring investors' confidence. I, therefore, urge the authorities to make an effort to challenge the remaining issues in structural reform.

Finally, with these remarks, I wish the Bulgarian authorities success.

Mr. Le Gal made the following statement:

First, I would like to commend the Bulgarian authorities for the consistency of their recent policy and their good economic results:

Economic activity has started to recover, although it remains fragile. Inflation has fallen to a 1 digit figure and the budget deficit is under control, while there are no tensions on currency.

These results are spectacular, particularly when one bears in mind the external environment and the poor performance of some neighboring countries. The currency board has certainly proved helpful to achieve these goals.

The success of the last Stand-by agreement owes a great deal to the medium and long- term strategy of the Bulgarian government which intends to join the European Union. Though the road will be long and much adjustment necessary, this goal will provide useful long-term guidance for economic policy making. With the proposed EFF as part of this strategy, we encourage the authorities to continue on this path.

But, as Mr Wijnholds sets forth in his preliminary statement, this does not mean there are no risks ahead.

First, it is difficult to assess how strongly the regional crisis will impact on the Bulgarian economy. The exports' recovery assumed in the medium-term scenario could be endangered if Bulgaria's trade partners fail to recover or if the shift toward new markets appears too slow.

Second, the Staff's growth prospects depend on a rather strong forecast for foreign direct investment, even though it has been cut from 4.9 percent of GDP in 1997 to 2 percent for the coming years. What will happen if these forecasts fail to materialize? The cautious sentiment of international investors toward emerging markets suggests that this continues to constitute a serious risk and Bulgarian authorities must be prepared for it. In this regard, governance issues must also be decisively addressed.

Third and finally, even with the approval of the EFF, there will remain a financing gap of USD350 million, necessitating the intervention of other donors like the EU or the G24. It should be recalled that EU financing is subject to specific conditions including the principle of aid burden sharing. In this regard, I welcome the fact that G-24 participants reconfirmed their existing commitments.

With these comments, I support the proposed decision.

Mr. Costa made the following statement:

Staff has produced a well-focused paper, and we share its recommendations, in particular regarding the need to preserve external competitiveness by deepening structural reforms in the enterprise and banking sectors. Income policies in the external enterprise sector should be strengthened, while advancing as quickly as possible with the privatization program. I share Mr. Shields' and Mr. Prader's comments in this regard. Reforms in these areas, coupled with further liberalization measures, will generate a powerful growth dynamic, without any need to stimulate the economy through public investment.

The authorities' intention to improve the pension system and the social safety net, in the wake of the better than programmed fiscal outcome, is welcome. However, strengthening the tax administration further to ensure medium-term fiscal sustainability, particularly given the present high levels of public debt and the unfavorable external environment, is also necessary.

Under a currency board arrangement, the domestic and foreign currencies should be seen as fully interchangeable, and shifts in the currency composition of monetary aggregates should not have any macroeconomic impact, except the one embedded in the logic of the currency board, that is, that interest rates denominated in foreign currencies should converge to the lower level of the anchor currency.

Could the staff comment on why—in the context of abundant liquidity, as highlighted by Mr. Spraos—Bulgaria has to resort to special official assistance to fill the financing gap, which does not appear as too large.

Efforts to strengthen the enforcement of contracts and the abatement of crime and corruption, which staff characterizes as one of the most difficult challenges facing Bulgaria, is a top priority. Finally, we support the proposed decision, and wish the authorities success in this program.

Mr. Melese d'Hospital made the following statement:

As other speakers have indicated, by their continued strong reform efforts the Bulgarian authorities have once again proven the pessimists wrong. The rewards for their efforts have so far been substantial: negligible inflation, low interest rates and strong reserves in the context of a credible CBA, balanced fiscal accounts, and good growth, with the strong promise of more to come if the authorities stay the course. Further, Bulgaria appears to have been less affected by the crisis than some others in the region, and I interpret this at least in part as a testament to the perceived stability of the country and solidity of the policy course, as evidenced most recently by the tough list of prior actions taken by the authorities in preparation for the EFF. Considering the dire situation Bulgaria found itself in less than two years ago, what has been achieved is indeed remarkable.

As I am in substantial agreement with staff's views and with their cautious and prudent policy advice to the authorities, I can be brief.

The most immediate potential risk to the program continues to be fiscal (or quasi-fiscal) relaxation, possibly in the context of adoption of a more growth-oriented economic agenda such as the one outlined by Mr. Spraos in his statement. Clearly, pressures to "borrow for growth" or to "spend the proceeds of reforms" have been strong for some time, and they can be expected to grow as the effects of reforms already implemented begin to show up more clearly in productivity, incomes, and in access to capital, although here I would note that the current crisis may have a salutary effect in terms of temporarily dampening such impulses. Given the still-fragile state of the recovery, the relative newness of key institutions including the CBA, and the volatile international environment (which takes on particular importance in light of the dependence of the fiscal program on the results of privatization), such impulses must at all costs be resisted.

In this light, the authorities should continue to exercise particular caution when implementing measures which will result in increased expenditures or reduced revenues with a view to avoiding any overshooting of budgetary constraints. If overshooting occurs, the authorities will have to move quickly to rectify the situation through immediate fiscal measures to preserve the credibility of the CBA.

Assuming fiscal, monetary and financial policies remain prudent, the biggest medium-term risk to the program is slackening effort on structural reforms. Such reforms hold the key not only to bringing Bulgarian living standards up to European standards in the long run, but also to the medium-term viability of the exchange regime, since, in the context of the CBA, markets can be expected over the coming years to quickly pounce on any perception that structural rigidities are compromising the fiscal program or external competitiveness. In this light special attention needs to be paid to reforms to increase flexibility in labor and product markets as well as to reform and privatization of SOEs, with a view to creating the kind of flexible and responsive private sector which will put a minimum of strain on the still-fragile debt situation and still-young CBA. In this light, I was pleased to note in Box 3 the last four prior actions having to do with phasing out subsidies, eliminating contract pricing on agricultural products, and restructuring the electricity sector, although it goes without saying that promises are easy but implementation hard, and nowhere is this more true than in the energy and agricultural sectors of economies in transition. We will be watching progress in these areas closely in the coming months.

Finally, I would just reinforce the comments of other Directors on the importance of moving forward in a timely fashion with pension and health reforms in a way which permits reduction of high labor taxes over time.

Mr. Vismantas made the following statement:

I have no difficulty in supporting the new Fund—supported program for Bulgaria. I join the previous speakers in noting the remarkable achievements by the authorities in stabilizing the economy and putting it quite solidly on the growth path. The recent developments under the stand-by arrangement are reassuring, and the content of the new program seems to be broadly consistent with the country's needs in the medium term, and also with the short-term requirements for vigilance, which arise from the external turmoil and changing perceptions of nervous markets.

Hence, there are just a few remarks I wanted to make. First, on the current account deficit, while it is generally accepted - at least in the community of investors of short-term capital - that a country is better off having a smaller rather than larger current account deficit, a number of the transition countries have relied on foreign savings to finance revival of their suppressed and investment-starved economies. By no means am I saying that excessive reliance, especially on the short-term credits, will bring prosperity to a country. But few could argue that a transition country like Bulgaria could achieve prosperity without a strong influx of foreign technologies and other needed foreign purchases. There is a conflict of objectives - one of a faster renewal of the economy, the other of a safe external position. But as long as the imports are financed by foreign direct investment and medium- and long-term debt, as long as the current account deficit stands behind productive investments which will later generate profitable exports, and as long as the authorities maintain prudence and understanding of possible risks in the approach, I wouldn't worry too much to see even a higher current account deficit than that projected for Bulgaria, if that should be the case. Of course, the effects of the recent regional and global financial turmoil call for a very cautious approach in the short-term.

Second, I have a strong feeling that enterprise sector reform is mostly needed on the structural front. Weak old-time, loss-making and budget-burdening SOEs are the least needed for the success of reforms. I welcome the progress of cutting these state enterprises from the bank credit lifeline, and strongly urge to continue their restructuring. There should be little hesitation on the authorities' side to undertake strong measures in order to clean up the enterprise sector and relieve the budget, and the economy as a whole, for that matter, from the least productive subsidies. Of course, the social variable needs to be kept in mind. Here, the World Bank's social protection program will be critical.

Finally, I note that the banking sector in Bulgaria has improved, after a healthy post-crisis clean-up last year. A rather short, but activity-rich history of banking sectors in some other transition countries, including those of our constituency, indicates the highly sensitive role the banks play in the transition process, and the strong importance the general public attaches to the banks' soundness when judging the overall success of the reform agenda of the country's political leadership. I very much encourage the bank supervisors to follow a tight approach which would promote the credibility and safety of the banks during the duration of the program and beyond. The authorities should spare no efforts and costs in ensuring autonomy as well as the high professionalism of the supervisors.

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

Mr. Donecker said that he agreed with what Mr. Melese d'Hospital had said. He wanted to record his authorities' support for the thrust of the staff appraisal and its recommendations, including the proposed decision. Given Bulgaria's currency board arrangement and the need for strong efforts with regard to structural reforms—particularly enterprise reform—he urged the authorities to continue to maintain a tight fiscal stance.

Ms. Wang stated that she broadly agreed with the staff appraisal and proposed decision. Although the authorities' efforts to accelerate structural reforms were commendable, the privatization plan was too ambitious. Adequate flexibility in the implementation of the privatization program was needed, with due regard for quality. Caution should also be exercised regarding capital account liberalization.

Mr. Singh made the following statement:

> Like other speakers, I would like first to commend the Bulgarian authorities for the impressive results they achieved under the SBA. Bulgaria's economic recovery remains, however, fragile and the agenda for reforms unfinished. We are convinced that the authorities are strongly committed to the transition process and that structural reforms will regain their momentum with the approval of the EFF. We therefore support Bulgaria's request.
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> As we agree with the thrust of the proposed program, I will limit my comments to a few points for emphasis.
>
> As for many other emerging market countries, the crisis in Russia poses a serious threat to Bulgaria. Although the turmoil has had limited effects on the country so far, its full impact may have yet to come. Should the Russian crisis deepen, serious adverse effects on Bulgaria's still mostly eastwards oriented economy should be feared. We therefore share Mr Shieds's concerns that the staff's projections for growth and for the evolution of the external account may be on the optimistic side and that some downward revision should be expected.
>
> Under these circumstances, the economy remains particularly vulnerable to any delay in the envisaged economic reforms. We were, therefore, concerned to read in the staff's report that the structural reform agenda set by the 1997 stand-by arrangement had not been completely implemented. We were, especially, worried about the delays in carrying through the isolation program which are leading to the imposition of unsatisfactory financial discipline on the public enterprise and banking sectors. Financial discipline is an important factor when it comes to the external competitiveness of these sectors which, in turn, partially determines the sustainability of the currency board. We would therefore encourage the authorities to step up their reform efforts in this area.
>
> Finally, as Mr. Prader pointed out, maintaining support for the reform process among the population will be important for the success of the program. In this respect, we welcome the payment of an extra month of wages and pensions to cushion the energy price increase. This measure

might be considered as a detail and is surely far from optimal. It might, however, foster public support for reform and thus be necessary at this moment.

Mr. Spraos asked Mr. Prader why he felt that there might be crowding out if public investment was increased, given that there was no real resource or liquidity constraint in the economy.

Mr. Prader responded that, while noting that there currently was no crowding out problem, it could emerge.

The staff representative from the European I Department stated that the program had been designed before the Russian crisis had emerged. Certainly, there would be some negative fallout from the worsening external environment. That fallout had been manifested in four ways in the program: (i) a decline in foreign demand, which was affecting exports; (ii) a higher risk premium for borrowing in foreign markets; (iii) reduced investment demand; and (iv) a reduction in what could be expected from privatization receipts.

A decline in foreign demand would negatively affect the external current account and growth, and would eventually require an adjustment, given that it was a permanent shock, the staff representative said. However, as pointed out by some Directors, there was scope for absorbing some of those shocks, given Bulgaria's high level of reserves. It would also be possible to finance a larger deficit in the domestic market. However, a careful assessment of the underlying strength of revenues and other aspects of the fiscal position would be needed first. Higher interest rates abroad were not likely to have a large effect on Bulgaria. The main effect would be a delay in accessing international markets, given the prohibitive cost. However, the lower LIBOR rates were helpful to Bulgaria, as its international debt and a substantial portion of domestic debt were linked to that rate.

The staff had attempted to quantify the impact of a deteriorating external environment in the macroeconomic framework, the staff representative remarked. By incorporating the most recent WEO projections, the reduction in foreign demand in 1998 and 1999 would lower Bulgaria's growth estimates by about 0.3 percent in 1998 and 0.5 percent in 1999. The current account would be weaker by about ¼ percent of GDP in 1998 and by ⅔ percent of GDP in 1999. However, the fiscal position could turn out stronger than projected, even recording a surplus, and this could limit the decline in the external position.

In response to comments on the 5 percent real growth projection for 1998, the staff representative explained that it would not be difficult for the economy to achieve that target, in light of the preliminary output figures for the second quarter of 1998. Real GDP for the second quarter of 1998 was 6.4 percent higher than the same quarter in 1997. If Bulgaria were to achieve the same level of output in the second half of 1998 as it did in the second half of 1997, then it would reach the 5 percent growth target. Certainly, there could be a weakening in the economy. For instance, industrial production has been weak all year; however, that had been offset by a good season in tourism, services, and construction. Another positive development was the significant decrease in unemployment. Given that there had been no increase in employment in the SOEs, that implied that the increase in employment had come from the private sector.

In response to questions on whether there could be a more expansionary fiscal policy, the staff representative responded that there was scope to absorb some of the shocks. That particular issue would be reviewed with the authorities in October 1998, when the 1999 budget be discussed with them.

The reason why Bulgaria needed to rely on official financing when there appeared to be an adequate level of domestic liquidity was to ensure that—over the medium term—Bulgaria could reach fiscal sustainability, the staff representative stated. Moreover, the need for official financing was underscored by the difficult external circumstances. As many Directors had mentioned, privatization receipts were likely to be less, and Bulgaria's access to foreign markets was questionable. Given the high cost of borrowing and Bulgaria's high indebtness, the authorities would have to continue to rely on official financing. Moreover, it was important to maintain the programed level of official financing because the authorities might then have to substitute some domestic financing to cover lower privitization receipts.

The Acting Chairman wondered whether the staff was worried about the risks to the program, given the current adverse external situation. Under the circumstances, he considered the 5 percent growth target impressive.

The staff representative from the European I Department pointed out that the economy had collapsed by 20 percent from the beginning of 1996 to mid-1997. Therefore, the economy was moving up from a deep trough. If the shocks were to last longer than what was projected under the WEO forecasts, then the outlook for 1998 and 1999 would need to be revised. The main revision would be a lower growth path for real GDP, and it would also take longer for Bulgaria to bring down its high debt-to-GDP ratio. Given that the Eastern European countries, including Russia, accounted for about 20 percent of Bulgaria's exports, a pronounced decline in the external environment of its neighboring countries would be detrimental to Bulgaria.

The Acting Chairman asked how vulnerable was the capital account.

The staff representative from the European I Department responded that the main risk to the capital account was lower inflows for privatization. Bulgaria was not vulnerable to capital outflows, unless there was a major loss of credibility domestically, which could cause domestic residents to take their resources out of the country. That was unlikely, as Bulgaria had a small amount of foreign capital, and its stock market was just getting off the ground. Moreover, available data had shown that foreigners' holdings of government securities was small. Therefore, Bulgaria was not too vulnerable to financial shocks.

Mr. Prader pointed out that if one included the central and south eastern Europe in Bulgaria's export share, the effects of deteriorating conditions would be larger. He wondered whether the staff had considered changing the assumptions under the program, given that the shock could be stronger. Also, he pointed out that the projected 25 percent decline in exports in 1998 was not particularly reassuring.

The staff representative from the European I Department clarified that the large decline in exports in 1998, when measured in U.S. dollars, was due to the large decline in export prices. On the other side, Bulgaria was gaining by the fall in the prices of its imports. The program had therefore projected a small terms of trade gain for 1998. In the case of Bulgaria, the effects of movements in commodity prices tended to be small because they affected both exports and imports. For instance, certain main exports, such as steel and chemicals, were dependent on fuel imports and other raw materials, and their prices tended to move together.

On whether the staff had considered to redo the program, the staff representative explained that the shock had come after the mission had returned. However, the effects of the shocks would be subject to the ongoing reviews, and the forthcoming 1999 budget would take into account any revisions in the outlook.

All countries in eastern Europe—not only Bulgaria—were being affected by external shocks, the staff representative noted. If those shocks were more protracted than the WEO had estimated, all countries in that region would be facing lower growth. However, it was difficult to determine how Bulgaria's economic situation would evolve.

Mr. Wijnholds made the following concluding statement:

> I thank Directors for their support for this important program, and also for their interesting contributions. There has been an enormous change in Bulgaria, and I would like to highlight the important role that the Fund and its staff have played in this transformation. The cooperation between the Fund and Bulgaria has been very intensive, and has, so far, been highly successful. Bulgaria is now at a stage where it has, for instance, been able to accept Article VIII status, and is marking progress under the EFF arrangement.
>
> It has been rightly observed that the medium term will determine Bulgaria's proving ground. During that time, the situation will become extremely difficult. Fortunately, the current government has another three years left until the next election, in parallel with the EFF. Given that the political situation is currently stable, that gives the authorities better ownership and a greater chance for the program to be implemented.
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> Mr. Spraos had a very interesting statement. He pointed out that the program was perhaps not ambitious enough, and that more should be done in terms of infrastructure, investment, etcetera. The authorities also share that belief, and the staff has therefore been more cautious. Perhaps as the program takes off and is implemented well, the degree of ambition could gradually increase. After several reviews, we would be in a better position to judge the situation.
>
> The impact on Bulgaria from the fallout of the Russian crisis and other countries in the region needs to be looked at closely. While I appreciate the staff's estimates, I personally feel that the WEO forecasts are still too optimistic. In that light, some of the effects might be stronger, especially if you take into account the third markets for Bulgaria. Bulgaria will probably be faced with lower growth, and it should not respond with a strong public investment effort. What should it do under these circumstances? Simply adjust in a downward fashion by tightening fiscal policy? Although that may be one response, one wonders whether that is the proper way to respond in the face of a severe worldwide recession. Should there perhaps be a combination of adjustment and financing? We need to think in a more general sense what the appropriate response should be from the countries affected by the Russian crisis. Certainly, there should be an

element of adjustment, as well as good implementation of policies, but perhaps there should be some thought given to additional official financing, given that this is an external shock beyond the control of the authorities.

The Executive Board took the following decision:

1. Bulgaria has requested an Extended Arrangement from the Fund in an amount equivalent to SDR 627.62 million for a period of three years from September 25, 1998.

2. The Fund approves the Extended Arrangement set forth in EBS/98/162, Supplement 1.

The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 11807-(98/104), adopted
September 25, 1998

3. INDONESIA—REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered a staff paper on the first review under the Extended Arrangement for Indonesia, together with the authorities' letter of intent (EBS/98/164, 9/11/98; Sup. 1, 9/17/98; Sup. 2, 9/24/98).

The Director of the Asia and Pacific Department remarked that the latest market developments were broadly in line with those of the previous day. The exchange rate had stabilized and ended trading below the mark of 11,000 rupiah per dollar. The stability in rice prices, the ebbing of protests, and the success of the Indonesian delegation at the Paris debt rescheduling talks appeared to have contributed to calming the markets.

With regard to the Paris Club agreement, the Indonesian delegation had obtained debt rescheduling for two fiscal years, the Director noted. That meant that a principal amount of just above $ 4 billion would be rescheduled, which was $2 billion more than had been included in the financing package earlier arranged by the Fund. That would contribute to easing the financing need in the next fiscal year. The Indonesian delegation had achieved a generous treatment of those debts related to official development assistance. They would be rescheduled for 20 years with a five year grace period. The interest rates applied would be concessional and in most cases equal the original rates.

Owing to the Paris Club's principle of comparable treatment of all creditors, the Indonesian authorities would have to reschedule a small amount of commercial bank debt - three syndicated loans, which meant that a London Club rescheduling would have to be agreed, the Director commented.

Mr. Zamani submitted the following statement:

The Indonesian authorities wish to convey to the Board their utmost determination and commitment to implement the economic stabilization and reform program currently underway. Hitherto, the Indonesian government has been broadly on the right track, judging from its complete observance of the indicative target for end-August 1998, relating to macroeconomic policies and financial restructuring. Monetary policy has been in line with the program, and the fiscal balance is well within the program limit.

Notwithstanding such strong policy implementation and growing confidence in the program, there remains concern over the impact of the crisis on the real economy, which has materialized on a wider scale. Therefore, the major tasks ahead are to implement structural adjustment policies promptly to minimize the social cost and, at the same time, to address potential social unrest due to the increased social and economic hardship.

To cope with this problem, the authorities have further developed some aspects in the program as set out in the Supplementary Memorandum of Economic and Financial Policies (MEFP) signed on September 11. The priority of the program remains focused on ensuring the effectiveness of the rice program, and bolstering bank restructuring and corporate restructuring programs.

Following the completion of the second review of the Stand-by arrangement in mid-July 1998, the rupiah exchange rate continued to strengthen from a level of 11,600 per US dollar to 11,000 per US dollar in mid-September. A fast disbursement loan from CGI in late July and a relative easing of the political and social situation in August contributed to the favorable development of the rupiah exchange rate. Nevertheless, the implementation of selective exchange controls in Malaysia in early September has created panic selling in the Jakarta stock exchange, owing to market speculation that Indonesia would follow the path of Malaysia. Consequently, the stock price index sharply dropped to around 290 in mid-September, compared to 415 in mid-August 1998. This evidence, on the contrary, has boosted the rupiah. However, further strengthening of the rupiah should be noted cautiously since, in the last few weeks, sporadic demonstrations have been recurring in many localities.

Despite favorable development of the rupiah exchange rate, inflation remains excessively high. The inflation rate rose by 8.6 percent in July and 6.3 percent in August, bringing cumulative inflation in the first eight months of 1998 to 69.1 percent, or 77.7 percent year on year. Increases in food price, especially for rice which has quadrupled over the past year, has been the major factor behind the skyrocketed inflation in July and August. A disappointing second harvest and some panic hoarding has contributed to the sharp increase in prices in recent weeks.

As food prices reached world levels regardless of the subsidies in such an acute economic contraction (preliminary estimate of real GDP growth in the third quarter of 1998 is negative 15.5 percent), it is even more urgent to shelter the poor from the effect of high rice prices. Accordingly, the government will extend a targeted subsidized food distribution program from 2 million to at least 7.5 million poor families to help the growing number of people living below the poverty line. The government would also increase the amount of rice imported and supplied by the state logistic agency, BULOG. To encourage additional supplies, BULOG would give up its rice import monopoly and the government will suspend VAT on rice and other staple foods. In order to improve the food situation, the government lifted subsidies on wheat, sugar and some other food products and will gradually phase out the subsidy on soybeans.

As regards monetary conditions, the authorities concur with the staff to maintain a firm monetary policy, aiming at safeguarding against inflationary pressures and stabilizing the rupiah. Provided that inflation declines and the rupiah remains in line with the program path, the authorities expect that interest rates will decline gradually. To this end, an indicative monetary program has been agreed with the Fund staff to guide policy implementation in the year ahead.

On bank restructuring, the authorities have reaffirmed their commitment to expeditiously implementing the restructuring program, which is considered crucial for overcoming the crisis. Following the government announcement on August 21, the Government intends to complete negotiations with the former owners of large intervened banks for the settlement of Bank Indonesia liquidity support as early as possible. In addition, some immediate programs have been scheduled, such as preparing a final plan for the restructuring of Bank Danamon, finalizing the strategy for recapitalizing and privatizing Bank PDFCI and Bank Tiara and finalizing the plan for recapitalizing and rehabilitating Bank Central Asia. In order to finance bank restructuring operations, the government plans to immediately issue bonds. Moreover, the government has submitted to Parliament a set of amendments to the banking law that would enhance IBRA's legal powers, allow the speedy transfer of assets to its asset management unit, reform bank secrecy law, and eliminate the legal restriction on foreign ownership of listed banks. It is expected that these amendments will be passed into law by October 20.

In the area of corporate debt restructuring, an additional framework, called "The Jakarta Initiative" has been launched to complement the newly amended bankruptcy law and the INDRA scheme. The initiative is intended to jump-start the recovery of the paralyzed private sector by providing incentives and removing regulatory obstacles to reaching out of court agreements on domestic corporate debt restructuring. The new initiative outlines the steps which debt-ridden companies should take when negotiating agreements with creditors on corporate and debt restructuring in order to give them access to working capital. The principle of the initiative covers, importantly, the provision of interim financing during workouts, which is essential for keeping viable corporations operational, and the provision of adequate information by debtor corporations, which will enable creditors to evaluate a company's business plan and its commercial viability. A task force is being established by the government to oversee the initiative and ensure that the initiative can be put in operation by end-September 1998.

Turning to the privatization program, despite the delay in completing the program as planned, the government is resolved to continue the privatization of state enterprises in a more selective way. It is admitted that the privatization of state enterprises is impeded by the investors' sentiment which is more cautious in the face of the recent domestic situation. Procedural difficulties, including those regarding regulatory and legal changes required in some cases, and concerns about selling assets when prices are very depressed have also been factors.

Privatization of PT. Krakatau Steel (steel industry) and PT. Telkom (telecommunication) is expected to be delayed. However, preparations in a number of suitable cases are well advanced, such as the privatization process of state-owned companies in plantation and infrastructure.

Finally, the Indonesian authorities reiterate their appreciation to the mission and Resident Representative for their invaluable hard work and timely assistance, and to the management of the Fund for their continued guidance and support. The authorities would like to reaffirm their adherence to the ongoing reform and adjustment programs. Continuous support from the international community, therefore, is indispensable so as to enable the reform process to pick up pace and to set Indonesia on a firmer path of economic growth and development.

Mr. Jadhav, speaking on behalf of Mr. Sivaraman, submitted the following statement:

At the outset, I would like to support the proposed decision for completing the First Review and allow Indonesia to continue to make purchases in accordance with the provisions of the Extended Arrangement.

I would like to make a few observations:

We should not be complacent on the rupiah strengthening from Rp15,000 per US dollar to Rp 11,000 per US dollar in early September as we are reasonably sure the value of the Indonesian rupiah has not been determined purely by economic factors. I am not willing to accept that the rupiah has been affected by the imposition of capital controls in Malaysia unless we have empirical evidence to prove this.

I have been previously alluding to the fact that we should not be over-optimistic about export performance in these countries. The depreciated value of their currencies will eventually take a toll on their exports in the form of increased cost of inputs. Despite my repeated requests, the staff does not seem to have paid adequate attention to an analysis of the import intensity of exports and its consequence for export growth in these crises countries. Appendix I in this regard is revealing. Despite their volume growth, the values have been almost 15 percent lower. The volume increase again would have been only by sale of accumulated stocks. The decline in export prices can also be largely attributed to the weak bargaining power of exporters on account of the highly depreciated value of their currencies. These factors should be taken into account in forecasting performance.

It is disturbing to note that market prices for essential commodities are reported to be converging with prices of international markets. With per capita income in Indonesia contracting, this should be a source of concern.

The fiscal performance, instead of being a source of satisfaction, should be a cause for worry as the government have not been in a position to increase spending in crucial sectors.

We would prefer the authorities increasing the prices of gasoline, electricity and aviation turbine fuel rather than reducing subsidies on edible items.

I am not overly concerned about the privatization program running behind schedule as I am against pushing the Indonesian authorities into a privatization schedule which would result in the sale of enterprises at distress prices. I would caution the staff from pressing the authorities on this matter and allow them to work out a proper framework so that privatization is carried out with transparency and is above reproach.

It is noticed that there are serious problems regarding making available essential items like rice and cooking oil at subsidized prices. Government should try distributing these commodities in substitution for part of the wages on public works as this will prevent the illegal sale of subsidized rice and cooking oil.

The launching of the Jakarta Initiative to accelerate corporate debt restructuring is a major step in the right direction. We must expect the progress to be slow in the initial stages before all the participants are able to bring their individual claims under restraint and look forward to rebuilding the corporate structure of Indonesia. The authorities and the banks involved should play a catalytic role in expediting the process.

We wish the authorities all success in the policy endeavors.

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

Indonesia has made further welcome progress under its reform program over the past month. Yet, economic and political conditions remain fragile, and the staff report highlights Indonesia's ongoing weaknesses in implementation capacity, especially in the critical area of fiscal policy and the social safety net. In these circumstances, the authorities must stick to and intensify their reform effort. Since the Board has discussed the broad strategy for Indonesian reform in recent months, the comments below are focussed on specific items.

Monetary Policy

Indonesia has adhered quite well to the monetary program, keeping NDA well under control and having now brought base money back on track. This favorable development has been facilitated in the recent period by the successful introduction of SBI auctions.

We strongly support staff's view that the authorities should avoid a premature easing of monetary policy. With base money now on track, any premature easing in the face of high inflation would undermine the tenuous confidence of markets. One of the lessons from Korea and Thailand is that firm and unswerving adherence to the monetary program over a period of several months was needed to begin restoring confidence, and hence allow for a firming in the exchange rate and a modest and progressive lowering of interest rates. With the rupiah showing greater stability and strength as of late and auction rates having come slightly off their peaks, Indonesia may well be on the verge of reaching this point. The gains of the past months should not be put at risk. Also, we welcome the authorities' public indication that they do not intend to introduce capital controls; controls might only serve to discourage inflows, including investment, at a time when capital is urgently needed to rebuild the country.

Fiscal Policy and the Social Safety Net

In June, the revised program correctly provided for a significant widening in this year's fiscal deficit to 8-1/2 percent of GDP in light of the international community's desire to help Indonesia mitigate the sharp contraction in the economy, the growing poverty and unemployment, and the possibility of humanitarian crisis. Significant international financing was mobilized by bilateral donors and IFIs for this very purpose. Yet, Indonesia ran a budget surplus in the first quarter of this fiscal year and development spending is still flagging.

In part, this surprising development is explained by a tradition of lower levels of spending relative to GDP, the lack of a well developed social safety net, and the ineffectiveness of subsidies and the need to abolish and replace them with targeted mechanisms. Indeed, the Board recognized long ago that Indonesian food subsidies were a second best solution and that they would create incentives for smuggling and corruption; the problem has exploded much faster than we expected. But given the dire situation on the ground, the authorities must urgently work with the IFIs on mechanisms to improve budget execution, accelerate spending and use resources effectively to limit the very real hardship its citizens face.

We welcome the adoption of the 7-point strategy to address problems in the rice markets. But we were surprised that BULOG has not released adequate rice supplies and would appreciate staff comments on this point. Further, paragraph 5 of the LOI states: "...in collaboration with the World Bank, we will develop a plan for the longer-term role and the corresponding restructuring of BULOG." The policy matrix notes a comprehensive international audit of BULOG is to be completed by end-year. We doubt that any plans could be formulated until the audit is complete. But since the IFIs may soon begin their work on BULOG's longer-term role, could staff share its preliminary thinking with us on this matter—does the term "restructuring" in the LOI suggest a continued governmental role, and does staff believe there is any need at all for a BULOG import monopoly in the years ahead? Has there been corruption in BULOG's past activities?

Also, we urge Indonesia to intensify its efforts to put the privatization program fully back on track. Could staff comment on whether the transparency of Indonesian fiscal decision-making has improved, including military spending?

Banking and Corporate Debt Restructuring

In the past two months, Indonesia has put in place arrangements to address the interdependent issues of banking and corporate debt restructuring.

Last month, we welcomed the August 21 bank restructuring program. Indeed, recapitalizing viable banks and getting NPLs off their books is essential for restarting loans to viable firms. But the success of the restructuring program will lie in its implementation. Thus, it is critical that the authorities, working with IFI staff, bear down on implementation issues and we look forward to the MAE progress report to be provided as part of next month's review. We hope this report will err on the side of detail. In the meantime, we would appreciate an update on banking restructuring developments in September and the results of the effort to collect repayments of liquidity support by September 21.

Further, IBRA's AMU will have a central role to play in both banking and corporate debt restructuring, but banking legislation—now before Parliament and intended to be approved in mid-to late-October—is needed to give the AMU sufficient legal authority to seize and dispose of assets. Accordingly, we would encourage the Board to include Parliamentary approval of this legislation as a prior action for completion of the next monthly review. Also, we continue to hear reports that delays are being encountered in merging the four state banks; if true, it is extremely regrettable and the authorities should move expeditiously to get the process going at full speed.

We welcome the recent launching of the Jakarta Initiative and would stress, as staff does, that corporate debt restructuring is an area where progress has been slow and must be urgently accelerated. Effective and credible bankruptcy proceedings are a critical lever for bringing debtors to the table. Debtors should also work closely in providing full and comprehensive information to creditors. Staff is to be commended for its work on bankruptcy. But now that the special commercial court has opened, could staff give us a read-out on how many petitions have been filed, and whether the court's proceedings are on track and petitions being properly handled. We also welcome the effort in the Initiative to facilitate seniority on the provision of interim financing to distressed companies; what are staff's expectations regarding the sources of such financing, and should such flows not emerge, does staff have any ideas on whether and how they might be catalyzed.

The Jakarta Initiative also envisions a limited facilitating role for the government in the context of a case-by-case framework. This approach places heavy reliance on voluntarism and is consistent with the views the Board has expressed in past sessions. It is important that we gain experience with the Initiative and see if it is capable of promptly addressing Indonesia's corporate debt restructuring needs. But given the enormous scope of the corporate debt problem and the limited capacity of corporations to negotiate complex workouts, staff should closely monitor whether the case-by-case approach suffices to help restore growth quickly.

Should progress not keep pace with Indonesia's pressing needs, consideration may need to be given to strengthening the incentives under the initiative, perhaps including through a more active governmental role. We hope that Fund and Bank staff are considering such ideas for the purpose of contingency planning.

Structural Reforms and Corruption

The policy matrix attached to the LOI highlights the key role of structural reform for Indonesia. This is an area in which the Fund is relying heavily on the Bank to take the lead. Nonetheless, structural reform is key for the ultimate success of the Fund program, for the credibility of this institution's work in Indonesia, and for creating a market-friendly environment that is transparent and minimizes the governance and pervasive corruption problems that have marred Indonesia's recent past. This point is particularly acute in light of the recent report from the World Bank's Jakarta office about corruption in Indonesia's procurement processes which was recently made public and offered a number of useful suggestions that IFI staff should pursue with the Indonesian government as a high priority.

So that we do not lose sight of these critical issues, we would appreciate it if staff—working with the Bank—could prepare a somewhat detailed Annex in its next monthly review on Indonesian progress in implementing structural reforms and in tackling governance and corruption problems. This report should also address Indonesia's progress in addressing core labor standards. Also, we would underscore that the structural measures to facilitate investment, deregulation, privatization and reform of public enterprises warrant close scrutiny. In this regard, we would appreciate staff's confirmation that the all-important international audits of Pertamina, PLN, BULOG and the Reforestation Fund are solidly on track.

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

It is encouraging that even under the most difficult circumstances, Indonesia's economic program supported under the extended arrangement remains on track. It is particularly encouraging that in spite of an unfavorable domestic and external environment, market sentiment is showing signs of improvement, and the rupiah is gradually gaining strength. We think that with continued firm implementation of the program, the rupiah could gradually attain the level of 10,000 targeted under the program.

But despite all this good news, the task ahead of the Indonesian authorities is still daunting, and there is no room for them to relax their efforts. Continuous implementation of firm financial policies, progress in dealing with bank and corporate debt, and an acceleration of privatization are all necessary, though not in themselves sufficient, for the success of the effort to overcome the present crisis. Indonesia's financial stability and the renewal of market confidence also depend on non-economic factors not always fully controlled by the authorities. But continued progress with macroeconomic stabilization and structural reforms should reduce the risk that events like the recent student unrest will undermine the program's objectives.

There has been much controversy about the role of interest rate policy in restoring market confidence. We are glad the authorities agree with the staff about the need to keep interest rates high for the time being in spite of their adverse effects on the corporate and banking sectors. We agree that reducing interest rates now could trigger a further depreciation of the currency. The translation of the weakening of the currency into higher domestic prices has been quite strong n Indonesia. Food prices are especially sensitive to the depreciation of the rupiah, which encourages smuggling and hoarding and heightens social tensions. A premature easing of interest rates could significantly destabilize policies and threaten the whole program.

We have doubted that authorities would be able to keep domestic food prices significantly below world food prices for very long, and we are glad that they have decided to eliminate most food subsidies. We continue to believe that in spite of some initial obstacles, improving the targeting of budgetary subsidies is a better way of providing social protection to the neediest without unduly burdening the budget.

But we are somewhat concerned that the overall budgetary position from April to August has been much stronger than programmed, mostly because of lower spending. With domestic demand very subdued, and monetary policy tight, it would be desirable for fiscal policy to provide some stimulus to the economy. We note one reason for the stronger than programmed budgetary position is because tax refunds are running behind schedule, meaning that the budgetary position is likely to weaken again once these refunds are caught up. But still, development spending was far below the target, and while we would not like to see public money spent on projects that are not well prepared, we would urge the authorities to allow fiscal policy to give more support to helping the economy recover from its present slump.

Data on export values suggest a disappointing performance, but export volumes have increased significantly. In fact, given the weakness of demand in regional markets, the performance does not seem that bad. But we would expect that a more stable domestic political situation, better access to trade financing, and gradual recovery in the whole region could reverse the weakening of Indonesia's export performance since May.

We appreciate that despite the difficult situation, the Indonesian authorities have shown that they intend not to resort to capital controls. We agree with the staff and the authorities that doing so would be counterproductive, and would immediately erase Indonesia's progress so far toward regaining market confidence. It would also put at risk the chances of success of the discussions on debt restructuring.

To enable the economy to recover, it is important to accelerate bank restructuring and the resolution of corporate debt. The present method of dealing with insolvent banks is rather cumbersome and does not allow a rapid resolution. We hope the amendments to the banking law aimed at facilitating this process will soon be approved. We also welcome the Jakarta Initiative, which should help speed up corporate debt restructuring. The newly amended bankruptcy law should provide a strong incentive to negotiate a debt restructuring agreement. It is particularly welcome that this amendment also addresses the problem of disruptive minority creditors by allowing the Commercial Court to make an agreement negotiated with and approved by a majority of creditors binding on all creditors.

We wish the authorities every success, and approve the completion of the review.

Mr. Shaalan and Ms. Abdelati submitted the following statement:

We welcome the recent signs of restoration of market confidence as evidenced in the stability of the rupiah and its convergence toward the program target level. It is heartening to see some tangible benefits from the continued adherence of the authorities to the program as well a number of important strengthening measures introduced in the past few months. Social tensions will not subside however, until economic activity picks up again, and this in turn is contingent on advances in bank restructuring and corporate debt work-outs which will permit a lowering lending rates. As we are broadly in agreement with the staff appraisal, we will only raise a few questions and comments on certain aspects of the program.

In spite of a tighter than programmed fiscal position in the first five months, and significant monetary tightening, inflation is running somewhat above the program level. The analysis described in Appendix II suggests a slowing of inflation during the coming months, and this, together with the anticipated strengthening of money demand, bodes well for the prospects of lowering interest rates. We look forward to a more positive outlook in this regard during the next monthly review.

Bank restructuring and the resolution of corporate debt are the most critical conditions for restoring normal financial relations and economic activity. Bank restructuring continues to proceed rather well, with the main outstanding element now being the parliamentary approval of the banking legislation that will further facilitate the transfer of assets to IBRA's Asset Management Unit. Corporate restructuring, however, as with the past two reviews, still poses a serious obstacle to economic recovery. While we welcome the elaboration of the new approach aimed at jump-starting the process—the so-called Jakarta Initiative, it appears that further work, and further assistance from the World Bank, is needed before its Task Force is fully operational. Clearly, the proof will be in the implementation, and like staff, we see significant merit in the completion of at least one successful debt restructuring case. This would have a valuable demonstration effect which may finally get the process going. We welcome staff views on why the process is still moving at a disappointingly slow pace.

Export growth is reported to be well below program projections (a decline of 2 percent compared to an increase of 4.2 percent for the first eight months of 1998) and staff point to "significant weakening" in export volumes since May. While we welcome the wealth of information provided in Appendix I which gives this subject the closer scrutiny it deserves, we are somewhat puzzled by some of its conclusions which are carried over into the main text of the report. The lower export values appear to stem more from the weakened world commodity prices than "supply disruptions and lost orders after the May riots. The chart does not show "significant" weakening in export volumes since May. However, some weakening should not be too surprising since the comparison is to the peak period of May–August of 1997. The slight decline in export volumes in the month of August, following significant strengthening of the Rupiah as envisaged under the program, is not necessarily a sign of "disappointing" export performance. We wonder if the program's export projections may have underestimated the impact of Rupiah appreciation, reduced regional demand, strong competition in third markets, and weakening of world commodity prices. Additionally, in view of the already strong performance of export volumes, and the assertion that export growth has been inhibited by the lack of trade financing, we wonder if export values are now expected to pick up the balance of 1998 once the export credit guarantee scheme, which was announced in July and experienced delays, is fully operational; or whether the stronger rupiah will further dampen export growth. Staff comments on these observations would be appreciated.

The delays in implementing the new social spending initiatives and the pace of development spending in health, education and employment generation in July–August are cause for concern and could negatively affect the implementation of the program. The overall budget position during the first five months of the fiscal year recorded a surplus instead of the targeted deficit. The increase in expenditures on social safety net programs was designed to address the impact of the sharp increases in food prices, rapid increase in the number of households living below the poverty line, and increased rural and urban unemployment. Delays in implementing these social spending programs could well contribute to rising social tensions. Although staff indicate that the authorities are taking steps to accelerate the pace of social safety net and development spending, we wonder if stronger efforts are needed by the authorities or technical assistance from the donor community to facilitate this effort.

Additional budgetary savings are arising from the elimination of food subsidies on several items (including on wheat, sugar and soybeans), and better targeting of rice subsidies. While we welcome these savings, we are concerned that the expansion of the targeted scheme for rice is proceeding at a slow pace and thus not reaching a large number of deserving households. What is the expected time frame by which the expanded rice subsidy program will have reached all deserving households, and is a similar program envisaged for cooking oil. Furthermore, is there a need for further support to the poorer families in view of the elimination of the other food subsidies in conjunction with rising domestic prices?

We commend the authorities in their determined efforts and support the proposed decision.

Mr. Mori made the following statement:

The Indonesian economy remains very weak with a sharp decline in real GDP of 12 percent in the first half of 1998, and a deterioration in export performance has recently added to this adverse scenario. We are encouraged by the progress made in policy implementation which has contributed to increasing market confidence reflected in the strengthening of the rupia. For an early reversal in the deceleration of GDP growth, it is important for the Indonesian authorities to persevere in following the appropriate mix of macroeconomic policies and implementing in a timely manner the economic restructuring program. However, it is also fundamental that economic performance improves in Indonesia's major trading partners, and that appropriate financial resources are made available to restore Indonesia's capacity to import. In this context, we welcome the disbursement of $1 billion by Japan's EximBank and urge foreign banks to maintain trade exposure under the trade facility component of the Frankfurt Agreement.

Under the current circumstances, fiscal policy is the main instrument to give the necessary stimulus to economic activity. It is essential for the authorities to pursue the targeted expenditure by accelerating the pace of development spending, especially under the new social spending initiatives on health, education, and employment generation.

Monetary policy remains another important component of policy implementation, and needs to be managed carefully to help stabilize the exchange rate and abate inflationary pressures. In this respect, the recent increase in inflation is a concern; cumulative inflation for the first eight months of the year has already reached 69 percent. In particular, the increase in the price of rice—an essential component of the consumption basket of the Indonesian population—reached recently almost 50 percent in only one month in Jakarta, though there was a supply-shock factor in this increase. We wonder whether the staff has any information on the evolution of real wages as well as financial instruments available for the Indonesian population to protect savings against inflation.

The elimination of subsidies for certain items such as sugar, wheat, soybean products, fish meal, and corn—as well as phasing out government intervention in certain markets—seems correct. The welfare purposes of subsidies are understandable, but their effectiveness is less so. Distortions may arise, such as illegal exporting and higher mark-ups by traders of subsidized items; benefits, therefore, tend to be reaped by intermediaries or third parties, not necessarily reaching the targeted consumers. Subsidies should remain in key areas, but with appropriate safeguards to reduce distortions. Government intervention in the rice and cooking oil market seem to be appropriate in the current circumstances, given the importance of these two items for low-income families. Although we agree with the authorities' objective of eliminating generalized subsidies over the medium term, this process should be carefully monitored and implemented in a more appropriate time frame.

Corporate debt restructuring and bank restructuring are essential elements to restore the normal functioning of financial intermediation. We are encouraged by progress in the financial sector, and expect an early approval of the amendments to the banking law. On corporate debt restructuring, the Jakarta Initiative—together with the bankruptcy law—is an important step forward to facilitate the process. Although the privatization program is running behind schedule, we see merit in seeking an appropriate timing for its implementation in view of the weaker domestic economy and the adverse shift in investors' attitudes toward emerging markets in general.

We support the proposed decision for the completion of the first review under the extended arrangement and wish the authorities well in their endeavors.

Mr. Daïri made the following statement:

Indonesia continues to make gradual but, it is hoped, decisive progress in dealing with the formidable challenge it had to face in a very unfavorable domestic and international environment. We welcome the strong determination and commitment of the Indonesian authorities to moving forward with their economic stabilization and reform program, as indicated by Mr. Zamani in his informative statement. The adequate policy implementation and increased financing of the program referred to in the staff paper have improved market sentiment, leading to a strengthening of the rupiah. We concur with the thrust of the staff appraisal and thank it for a clear and well-focused paper.

The decline in real GDP in 1998 is worrisome. Together with rising unemployment and high inflation, it underscores the need to continue to focus on ensuring the adequate supply of rice, including to the poor, and advancing bank and corporate debt restructuring. Maintenance of the present monetary stance seems unavoidable despite its heavy toll on the corporate and real sectors, if confidence is to be restored. A prudent easing should be contemplated in line with progress in the stabilization of the economy. I share Mr. Shaalan's and Ms. Abdelati's reservations regarding the staff paper's assessment of the export performance.

The budget position has improved significantly compared to program targets. The surplus during the first quarter of the fiscal year compares to an expected 8.5 percent deficit. While the elimination of subsidies on many food products contributed to this outcome, it also resulted from the decision to scale back the public infrastructure program and from delays in social spending as well as in the payment of tax refunds. Could staff or Mr. Zamani comment on the reasons behind these latter developments, given they occurred at a time when financing was available and the fiscal stimulus was badly needed? We are somewhat surprised that a table summarizing fiscal developments was not included in the staff paper.

We support the extension of the targeted subsidized food distribution program to cover at least 7.5 million poor families. This is most appropriate in view of the increase of the number of people living in poverty, which is estimated to be at some 50 million. We are pleased to learn from the staff paper supplement that the program coverage has already reached 4 million families, from 2.5 million some weeks ago. We also welcome the measures taken by the authorities to improve the food distribution system and to enhance competition in the market. These actions are expected to bring down inflation expectations and to improve the political situation.

The authorities' determination to expedite the implementation of bank restructuring is welcome. The recent agreement with two of the three largest intervened banks on the transfer of assets is encouraging. I welcome some clarification on the maintenance of a minority stake by some of the former owners of one of the banks. I would also like to know why criminal proceedings would be initiated in cases where former owners cannot settle outstanding liabilities to Bank Indonesia. In my view, such proceedings should be based on evidence of infringement of the law and not on inability to pay.

We note the authorities' expectation that the amendments to the banking law will be adopted by end-October 1998, and we encourage them to speed up the disposal of acquiring assets. While we share Ms. Lissakers's emphasis on the importance of early approval of this legislation, we do not see it as appropriate to include it as a prior action for the next monthly review.

Corporate restructuring is gaining new momentum, with the announcement of the out-of-court negotiations framework of the so-called Jakarta Initiative that complements the bankruptcy law and the INDRA scheme. We are pleased to note that the government's role is limited to facilitating and encouraging implementation of this initiative.

We support the authorities' intention to proceed with the privatization program in a more selective way and share their legitimate concern about the disposal of assets in a very depressed environment, which might jeopardize the future of the divested enterprises and alienate public support. However, it is important to continue preparing public enterprises for privatization, including through restructuring and approval of the necessary regulatory and legal changes.

As regards the timing of future privatization measures, care should be taken in striking the right balance between the need to secure a fair price and the need to build investors' confidence. We support the proposed decision and wish the Indonesian authorities every success in their endeavors.

Mr. Ono made the following statement:

It is encouraging that through continued policy implementation, market sentiment has further improved and the exchange rate has been relatively stabilized. At the outset, this chair appreciates the authorities' efforts at implementation of economic reform. However, real GDP growth is now estimated at minus 15 percent and this estimate has been revised downward on each review. I would note that repeated downward revision might cause one to wonder if the staff realizes the seriousness of the Indonesian recession. As discussed at the recent Managing Director's luncheon, some Director's have raised the concern that continuation of the overestimation of the economic outlook, which is an important base for fine-tuning the program, would hurt the credibility of the Fund. In addressing the issue of very weak economic activity, I think it is urgent for the authorities to sufficiently utilize the fiscal outlay capacity as determined in the program in order to activate the economy. At the same time, it will be necessary for the authorities to hasten implementation of financial sector reform and corporate debt restructuring so as to activate the private corporate sector. I think that making room for the easing of monetary policy through a steady implementation of these policies mentioned above will provide a shortcut for putting the Indonesian economy on the path to recovery. Of course, at the same time, the sharp increase in the inflation rate needs special attention. In this regard, I concur with the staff that the authorities should stabilize the rice market, which is the main cause of the current inflation. From the point of view of securing social stability, I think appropriate action on the part of the authorities in this field is quite important.

Now, I would like to comment on some important issues.

First, on fiscal policy, considering the current severe recession, a supportive stance for economic activation is essential. In this regard, I think the acceleration of spending development would be appropriate. Improvements in the targeting of the Social Safety Net are also welcome for the purpose of maintaining a disciplined fiscal policy and protecting social weakness. In my opinion, what is most important in this regard is that rapid implementation of these rightly directed policies without slippages is required.

Second, on monetary policy, I can understand the necessity for continuing a prudent policy at this moment. Having said that, as the staff indicates, current inflation is due mainly to structural reasons on the supply side. Therefore, the authorities should be careful not to take an excessively-tight monetary policy owing to the price increase caused by this specific factor. In this sense, I think a proper policy combination would be for the authorities to take effective and bold supply-side measures to reduce inflation, especially in a food price hike, and seek cautious monetary policy easing by taking the opportunity when the foreign exchange market is stabilized.

Seeing the current turmoil in the rice market, I am worried about the measures taken to improve the food distribution system being implemented smoothly. I would like to hear from the staff the reason for this turmoil, in spite of the best efforts on the part of the authorities through various measures as explained at the previous board meeting. At the same time, I would like to know what kind of measures will be taken in the future to prevent such insufficiency from occurring.

Third, regarding corporate debt restructuring, it is welcome that forward-looking measures are being taken, such as the Jakarta Initiative. I hope that corporate debt restructuring is implemented immediately, otherwise, economic recovery will be delayed further. It was explained in the staff paper that the Jakarta Initiative supplements the past restructuring scheme. However, it seems that the INDRA scheme has not been activated adequately so far. I heard that not even a draft form of the detailed contract based on the INDRA scheme was prepared as of mid-September. I would like to know the staff's view as to what extent activation of the INDRA scheme will be promoted by the new Jakarta Initiative.

Fourth, on financial sector restructuring, I think that the amendment to the Banking Law which was submitted to Parliament is effective in promoting reform, so I hope it will be approved immediately.

Fifth, regarding trade finance, our authorities support the Indonesian export industry through Japan EXIM Bank's loan. I believe that this loan will contribute to removing the difficulty in importing parts and raw materials through letters of credit, which are generated by the lowering of confidence. This loan supplements implementation of the Fund program, and, in particular, contributes considerably to Indonesian economic recovery.

In order to activate the export industry through an utilization of the JEXIM's loan, I strongly hope that the authorities speed up their efforts to make the export credit guarantee scheme operational. This scheme is indispensable in order for our loan to actually be utilized. In this regard, it is welcome that operational guidelines were issued last week. This chair looks forward to early activation of this important guarantee scheme.

Finally, I welcome that negotiations on public debt restructuring were completed successfully at the Group of Official Creditors of Indonesia meeting held in Paris on September 22 and 23. I would like to inform the Board that our authorities decided to provide new money equivalent to about US$1 billion before March of next year in order to maintain market confidence in Indonesia.

With these remarks, I support the first review under EFF, and wish the authorities success in economic reform.

Extending his remarks Mr. Ono noted that in every monthly review, the staff projection for the outlook for the Indonesian economy appeared to be downwardly revised. He expressed concern that market participants might wonder about the Fund's assessment of the future economic outlook and whether the Fund staff was fully serious in assessing the economic downturn in Indonesia.

The Acting Chairman replied that calling the staff's seriousness into question was inappropriate in view of the remarkable work the staff had done in Indonesia. He expressed his regret that such a statement was being made about the staff.

Mr. Askari-Rankouhi made the following statement:

The attitude of the Indonesian authorities has shifted in favor of the Fund-supported program and there are increasing signs of their ownership of the program. The authorities should be commended for their efforts, and the staff should be congratulated for its important role. However, there are still questions regarding some of the developments in Indonesia and some aspects of the program.

With regard to macroeconomic questions, our main concern is the underperformance on budget spending. In the current circumstances, where monetary policy is constrained by exchange rate concerns, the government has a critical role. It should ease the adjustment process through effective and accurately targeted social spending and help stimulate economic activity through development spending and public infrastructure programs. What are the reasons for scaling back public infrastructure expenditure and delaying social spending?

The staff paper does not reflect the concerns raised at the last Board meeting with regard to the rice subsidy scheme. Could the Bank staff elaborate on this scheme and in particular on the total number of families eligible for the subsidy under the scheme as well as on the targeting procedure and the criteria on which it is based. Do families qualify for the subsidy according to their income level or is there another criterion? Given the scheme's importance in the context of the fragile political environment in Indonesia, it would be helpful to have a more detailed explanation of how it works and how its misuse can be avoided.

We welcome the government's seven-point strategy to address the issue of rice provision, but wonder why Bulog has been so slow in releasing rice to the market. Transparency is crucial in the operation of Bulog. We would therefore like to know exactly what mechanism is in place to monitor it.

With regard to privatization and corporate restructuring, I wonder whether we need to push for broad and speedy privatization of state enterprises at this juncture, given the low level of investor confidence and the sharp decline in economic activity. Privatization aims at enhancing efficiency and thus certainly has to be a part of a medium-term strategy. However, the immediate problem in Indonesia, is not whether goods and services are produced efficiently, but whether they are produced at all. Therefore it is much more important, at this stage, that the authorities focus their efforts on corporate restructuring rather than on privatization.

On debt rescheduling, could the staff explain whether there is still any financing gap left for the next fiscal year with the rescheduling of $2.4 billion in the context of the Paris Club?

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

Mr. Taylor made the following statement:

Apart from supporting the proposed decision I would only like to add to some of the questions that have been raised in four main areas: monetary policy, foreign exchange cooperatives, rice distribution, and privatization.

In the area of monetary policy, I would appreciate an explanation on how the volume of SBIs is currently determined and whether the market clears at every auction. In the area of bank restructuring, nine of the fourteen banks appear to have failed to clear their liquidity injection repayments, including at least one important bank. Could the staff or Mr. Zamani comment on what should happen next? In this context, I would welcome the MAE review that is envisaged for the next meeting on Indonesia, and I hope that it will be coordinated with the World Bank.

The staff paper says that it is not intended to influence the exchange rate on a day-to-day basis through sales of foreign assets by Bank Indonesia. However, as such sales would, of course, influence the market to some extent, I wonder whether the staff could elaborate on the overall nature of the foreign exchange market. What is their volume and nature, and are there any off-market transactions at present?

On cooperatives, could the staff provide information on whether they are financed on- or off-budget and which are the overall financial implications of the cooperatives in the current circumstances? It is also of interest to know what the principle objective of the cooperatives is, whether it is employment or some other economic objective, or the displacement of Chinese business activity. Do cooperatives have a significant role in food distribution, and how do they work in a sector like forestry? Are the recurring civil disturbances over rice predominantly about food distribution or are there other issues currently leading to unrest?

There are some questions I would like to address to the representative from the World Bank. In the context of rice distribution, I wonder whether the various measures to increase supply would not lead predominantly to an increase in smuggling and an increase in fiscal cost rather than to a reduction in the price. To take Mr. Askari-Rankouhi's questions on the targeted distribution to the poor further, I wonder how the Bank knows that the rice reaches the right people, and how does it know who the right people are?

I wonder whether the Bank would have a comment on the alternative to rice distribution mentioned by Mr. Sivaraman. We are all concerned about the situation, but it had been expected to be difficult and this outcome is therefore not anyone's fault. However, it would be helpful for the Board if a paper could be provided by the Bank staff at the next Board meeting on the issue of rice distribution.

With regard to privatization, I am rather concerned at pushing ahead too fast. Is the Bank staff fully satisfied that administrative structures in Indonesia can cope with the privatization process both efficiently and transparently at this stage? Could Bank staff clarify the Indonesian policy position on foreign ownership in the banking sector and in other parts of the economy?

Mr. Esdar made the following statement:

I was also pleased to note that Indonesia's program implementation has stayed within the agreed targets. The still volatile exchange rate situation and the very fragile economic environment demonstrate the need to fully implement the program in all its elements but also in its spirit. Therefore, we would like to commend the authorities for their efforts so far.

We had an intensive discussion on the economic situation and the program requirements four weeks ago, and it is certainly not surprising that many points which were made there are still true. We also very much share staff's findings and recommendations in its clear and well-focussed paper.

On monetary policy, we strongly endorse staff's view that continued tight monetary course is required to further strengthen the exchange rate but also in light of the recent price increases. As developments in Korea and Thailand demonstrate, if confidence has been reestablished and exchange rate developments have gotten under control, room may develop relatively quickly. A premature easing, however, would have adverse effects. I noted the liquidity support to banks in August was slightly above program targets. I would like to reiterate our recommendation to replace the liquidity support scheme as soon as circumstances permit with market-based instruments.

On fiscal policy, while welcoming the generally encouraging performance, I share the staff's concern that automatic stabilizers have not been used to their full extent. I am concerned in particular that there was a significant under-performance in financing and implementing social programs. To back the adjustment and reform efforts by a well-targeted and sufficiently equipped social program is crucial not at least to strengthen ownership and public support for the reform efforts. I would appreciate if the representative of the World Bank could enlighten us how the World Bank could help avoid future slippages in this important area.

This brings me to food security. I appreciate that the "seven-point strategy" for tackling the urgent problems will try to address the shortcomings of the scheme. The fact that subsidized food commodities have been illegally exported, demonstrates the limitation of price subsidies. While I acknowledge that the scheme is intended to be only a temporary one, I still would like to ask the question whether directly subsidizing income or providing food stamps could mitigate some of the logistical problems and prevent misuse. As this is very much a World Bank responsibility, I would appreciate comments from the colleague from the World Bank.

On bank restructuring, the staff correctly focusses on the need to keep and—where required—to accelerate the momentum of reform to offset delays experienced during recent months. In this regard, it is in particular crucial to approve the amendments to the banking law as a precondition for an efficient working of the "Asset Management Unit (AMU)". It would be helpful if the parliamentary process could be accelerated; however, October 20 should be regarded as deadline.

It is disappointing that there was not much progress in the area of corporate restructuring. We hope that the announced "Jakarta Initiative" together with the new bankruptcy law will set the right incentives to come to sustainable solutions in this crucial area now.

Further on structural reform, I fully endorse the encouragement by staff to avoid further delays and to speed up the process of privatization.

I support the proposed decision.

The Director of the Asia and Pacific Department, referring to an issue raised in the preliminary statements of Mr. Daïri, Mr. Askari-Rankouhi, and Mr. Esdar, said that the widening of the fiscal deficit to 8.5 percent of GDP had been agreed because of the need to shift toward an expansionary fiscal stance, which had also been supported by the additional financing package organized by the Fund. The expanded deficit would be committed to increasing expenditure, especially on subsidies, employment creation programs, basic health care, and elementary education.

Partly owing to administrative problems and to the fact that the authorities were not used to such rapid changes, the shift toward the expansionary fiscal stance was coming about only slowly, the Director continued. The authorities were also hesitant to make these changes rapidly and to short-circuit the transparent regular process to avoid being accused of following poor governance practices. Substantial technical assistance would be required to accelerate the shift. The World Bank would take the lead, and was already engaged in an expenditure review. The Fiscal Affairs Department had also reviewed expenditures, in particular social expenditures, and would provide a long-term advisor.

The psychological barrier of hesitating to commit to a rapid increase in expenditure in the face of declining revenues was another problem in moving rapidly towards an expansionary fiscal stance, the Director stated. That attitude was certainly advantageous in normal times, but was somewhat of a hindrance in the current circumstances when a quick shift in fiscal policy was needed. The staff had not included a table on fiscal data for the current review because it would have been practically unchanged from the table presented the previous month.

Replying to a question from Mr. Daïri on why criminal proceedings were only raised against those owners of banks who had not been able to fully repay the liquidity credits, the Director remarked that he was not aware of such cases. The actual policy was that criminal proceedings would be initiated against any bank owners, if there was evidence that they had engaged in illegal acts, like connected lending and using liquidity credits for other than the agreed purpose.

Addressing the question on food distribution raised by Mr. Ono, the Director said that the previous system had to be unsustainable, because of the very large gap between domestic market prices and foreign prices, caused by the depreciated exchange rate. A wide price gap was an open invitation to smuggle rice and other foodstuffs, like cooking oil, to places like Singapore. It was difficult to intercept that, given that Indonesia was a very open economy. The gap had been closed rather quickly and under somewhat chaotic circumstances accompanied by some speculation. The precipitous closing of the gap could probably have been avoided, if BULOG had released rice in a more timely manner and in larger quantities. That would have allowed for a more gradual price adjustment, which would in turn have diminished the scope for speculation, hoarding, and exporting.

Another factor contributing to the confusion and to localized shortages were shortcomings of the distribution system, the Director remarked. The attempt by the government to supplement the distribution system by involving cooperatives had been one reason for those problems, given that this was, at best, a medium-term process and thus had caused friction in the short term.

The reasons for the deficiencies in the way BULOG had released rice were not evident, the Director continued, but were partly due to logistic problems of BULOG's about 200 warehouses all over the country. There might also have been some hesitancy because imports that had been contracted to replenish stocks had been arriving at a slow pace. At the time of the staff mission, only 40 percent of the imports contracted to be available by the end of September had actually arrived. This difficulty in importing could also have had an impact on the release of rice.

In response to a question by Mr. Ono as to whether the staff's forecasts should be taken seriously by the market, given that they had been revised downward, the Director commented that Indonesia was in a crisis and in a very fluid situation. Any forecast might be overtaken by events within a short period of time. One of the rationales for monthly reviews was precisely that forecasts could be kept up-to-date and plausible.

With regard to the GDP forecast, the Director noted that the staff had initially forecast a decline of 12-15 percent. At the time of the previous month's review, the conclusion had been that the likely outcome was closer to a 15 percent decline. This represented a slight downward revision, but it was in line with other market forecasts. There could be no guarantee that the next forecast would be exactly the same as the present one, as there were many events that could not be foreseen; some of these were also outside the control of the authorities, like the deterioration in the outlook for Japan and Korea.

On BULOG's operations, the Director remarked that they had never been transparent in the past and that, for that reason, the new head of BULOG, who was also the Minister of Trade, had agreed to a monitoring mechanism within the agency. It had not yet been decided whether this function would be performed by a monitoring committee or by an office in which all administrative information would be gathered. Following the lead of the World Bank, the Fund had already started to collect daily statistics on rice prices of the three main qualities in the market and the corresponding prices released by BULOG. Data on the stock and import situation, as well as on comparable rice prices in Singapore, were also being collected. While a beginning had thus been made, a substantial amount of work remained in that area.

Adding to his earlier comments on cooperatives, the Director stated that, at present, they did not play a large role in the distribution of rice, but that they were intended to play such a role in the future so that there would be a two-track distribution system consisting of the traditional traders and the cooperatives. Smuggling would be less likely to occur, given that the difference between the world market price and the domestic price in Indonesia was less than 15 percent, which rendered smuggling practically unprofitable.

Concerning the financing gap in the coming fiscal year, the Paris Club had helped, and under the current forecast, only a small gap of between one to one and a half billion was expected.

There had been two types of civil disturbances recently, the Director stated. One was looting and localized rioting mostly related to food prices, the other was student protest, which resumed with the beginning of the academic year. Those protests had been partly a reaction to the high price of rice, but they also had a political agenda, namely to bring about the resignation of the President and the introduction of an interim administration.

Replying to a question raised by Mr. Mori in his preliminary statement concerning the evolution of real wages, financial instruments available to protect savings and real incomes, the Director noted that deposit rates were around 60 percent and, therefore, protected savings from inflation. The salaries of civil servants, including the military, were partly being paid in rice, which also offered some protection of real incomes.

In response to a question from Ms. Lissakers on whether the transparency of decision making in fiscal policy had improved, particularly with respect to military spending, the Director said that both the World Bank and our Fund Fiscal Affairs Department were working on the problem. The acceleration of social spending would indeed require stronger efforts by the authorities, but also technical assistance from international financial institutions and the donor community.

Mr. Mori remarked that, when addressing the question of wages and real income, one had to take account of the fact that only a part of the population had access to bank deposits. Hence, for the poor, stockpiling rice would be the only way to save in circumstances where inflation was created by problems in the rice supply. The appropriate monetary policy response in that situation would be to increase interest rates so as to discourage speculation. In the current case, however, it was more important to normalize rice prices by supplying rice in sufficient quantities.

Mr. Eyzaguirre agreed with Mr. Esdar and others that any premature easing of monetary policy would not be appropriate. However, it was somewhat puzzling that monetary policy was apparently supposed to be geared toward providing exchange rate stability as well as containing inflation. That seemed to suggest that monetary policy would affect inflation in other ways than it affected the exchange rate. Clarification of the aim of monetary policy was needed, particularly in a situation of deep recession.

Referring to remarks made by Mr. Mori, Mr. Eyzaguirre said that other governments had found it useful to provide indexed bonds as a way to reduce interest rates and to provide an asset for the population that helped protect their savings. Also, indexed bonds would reduce the tendency to shift into dollars to protect the real value of their savings, which might also be helpful in the current situation prevailing in Indonesia.

Mr. Giustiniani, referring to comments from the staff and from Mr. Taylor on the tightening of monetary policy and the stability of the exchange rate, wondered whether exchange rate developments might be an accurate indicator for monetary policy, given the limited trading volume in the exchange market in the present situation. The impact of aid flows might also have an effect on the exchange rate.

With regard to inflation, the year-on-year rate showed a steep upward trend from 18 percent to 81 percent in August 1998, Mr. Giustiniani continued. That implied that the increase in interest rates had not been sufficient to bring them into the positive territory in real terms. Therefore, the question remained whether, in the light of these data, the particular policy mix of tight monetary policy and accommodating fiscal policy agreed by the Board had effectively been put in place.

Mr. Ono, extending his earlier remarks on the staff's economic forecast, stressed the importance for the Fund to make realistic assumptions particularly at this juncture, and asked the staff to comment on whether there was a downside risk to the present forecast of a drop of 15 percent in GDP growth. He expressed his hope that, in the next monthly review, the forecast would not need to be revised further downward, but that the situation would improve and might allow an upward revision.

The Director of the Asia and Pacific Department replied that the staff also hoped that growth would improve and the inflation target on which the monetary program was oriented would be reached. The recent acceleration of inflation had been due to higher food prices, which was mostly the consequence of supply side problems. Therefore, the prospects were good for inflation rates to come down. Over time, provided that the exchange market continued to stabilize, this would allow a cautious easing of interest rates.

Replying to a question concerning the point in time when the expanded rice subsidy program would reach all deserving households, the Director said that the number of deserving households was estimated to be between 15 and 17 million. At present, the aim was to reach all of them by the end of 1998. At the moment 4 million households were covered by the program.

There was no plan to have an expanded subsidy program for cooking oil, the Director continued, as it was expected that the price of cooking oil would remain stable or decline. Indonesia was an important producer of palm oil, which was the basis for cooking oil, and the country produced more than it consumed domestically. With the price presently approaching world market levels, problems should subside. However, the situation had to be kept under review, given that cooking oil was among the most important staples.

Referring to a question on the need for further support of poor families in view of the planned elimination of food subsidies, the Director stated that the main support was coming through the targeted rice program. Indirect support would be provided through the employment creation programs as soon as they were activated.

The staff representative from the Policy Development and Review Department, commenting on questions raised in relation to monetary policy, said that it was directed both at the exchange rate and inflation. The charts on inflation in the annex to the staff paper showed that inflationary developments had been closely linked to movements in the exchange rate. If the exchange rate was stabilized, as had been successfully done in recent weeks, inflation should come down, provided there were no more semi-exogenous food price shocks. It seemed therefore sensible for monetary policy to be directed, to a considerable extent, at stabilizing the exchange rate, as had been the case in the past weeks.

Addressing the question on indexed bonds and whether they had a role to play in the present situation, the staff representative commented that the issue had been discussed during the last mission, including with Arnold Harberger, who was visiting Indonesia at the time. There had been agreement that they could play an important role in preventing real interest rates from being excessively positive when inflation was coming down. If there was success in bringing inflation down, interest rates would probably follow with a lag, thus leaving interest rates in positive territory in real terms for some time. Indexation of financial instruments could be a way to mitigate that effect. However, it was necessary to be reasonably certain that inflation was coming down when considering the use of indexed instruments in such a way. Otherwise, their use could be a problem rather than a help. It had generally been agreed that one should be cautious about adopting that approach at this point.

Responding to a question raised by Mr. Taylor, the staff representative said that the volume of central bank certificates (SBIs) was determined by using a procedure that the monetary monitoring committee helped develop with Bank Indonesia. The amount of SBIs to be sold was determined on the basis of what was needed to keep base money on track, taking into account the number of SBIs falling due and the other transactions predicted within the central bank's balance sheet. Banks would then bid for SBIs, and the cut-off point was more or less the amount that needed to be sold, with the interest rate determined by the market. The last auction had been substantially oversubscribed, partly because market participants were starting to be concerned that interest rates would come down. That led to somewhat lower interest rates at the last auction; they had recently come down to 67 percent from 70 percent.

On the foreign exchange market, the volume of transactions per day in recent weeks had been about $ 300 to 500 million, the staff representative continued. That was much less than the year before, but it was quite a large volume in relation to the amount of the steady foreign exchange market intervention by Bank Indonesia, which was about $ 15 million per day. That intervention was part of the basic architecture of the program. There were one or two large transactions that had been performed off-market by Bank Indonesia, however at the market rate. That had been necessary in cases where BULOG or other large entities needed to arrange a large transaction, because the market was relatively thin. The Bundesbank advisor, who was member of the monetary monitoring committee, had informed the staff that procedures of this kind were not unusual even in more sophisticated and more developed financial markets.

Addressing questions on export performance raised by Mr. Shaalan and Ms. Abdelati, the staff representative said that export volumes had declined further since May. The chart in the staff report contained three-month moving averages that were declining, despite the rebound that had occurred in June following the very depressed level seen in May. However, if one looked at the results for July and August, the index of export volumes was around 107 compared to an average of 127 for April and May, and the volume for July/August was about the same as those recorded in the previous year. Hence, there was some evidence that export volumes had dropped somewhat since May. That was also in line with the anecdotal evidence from major exporters and their associations.

Replying to a question on whether the staff had underestimated the effects of regional economic weakness and competition in third markets, the staff representative conceded that might have been the case. The staff assumption for the fiscal year as a whole had been that export values would rise by about 4 percent. At the moment they were down by about 2 percent. The staff probably underestimated the strength of volumes, but also underestimated the weakness of values. While the staff had tried to be conservative in their assessment, it had turned out in retrospect that the staff had not been quite conservative enough.

The various trade financing initiatives should help support export volumes in the coming months, the staff representative continued, but the regional environment would not provide substantial help. The Japanese economy remained weak, and competition in third markets would continue to be intense. Hence, there was little reason to be optimistic about a significant pickup in volumes in the period ahead.

Most questions on bank restructuring had been answered by the supplementary statement provided by the staff, which updated developments, particularly on progress in collecting liquidity support, the staff representative said. As far as the merger of the four state banks was concerned, the legal merger should take place close to the deadline at the end of the current month. A new bank was going to be created to take over the shares of the component banks, with a well-known international bank holding the management contract for the new bank. It was also envisaged that the necessary bond issues to recapitalize banks and to compensate banks that were taking deposits for closed banks would take place shortly.

On the question about the audits of Pertamina, BULOG, reforestation fund, and others, the staff representative said that they did not appear completely on track. The terms of reference for those audits had been prepared, and the World Bank would follow up on progress with them.

Responding to a question from Mr. Shaalan and Ms. Abdelati as to why corporate debt restructuring had been progressing slowly, the staff representative commented that one of the reasons was that there had been enormous economic uncertainty, particularly about the future of the exchange rate. That had made it difficult for corporations and their creditors to make decisions on restructuring plans. Some creditors had adopted a wait-and-see attitude, at least until recently, in the hope that there would be some form of government bailout. They should by now have understood that this was not going to be the case.

The weak bankruptcy procedures had provided debtors with little incentive to come to the negotiating table until recently, the staff representative continued. Another problem had been that debtors had been unwilling to provide full information on their financial conditions. Many had engaged in some questionable practices that they might not wish to reveal. Creditors in turn were unwilling to proceed without complete information. Yet another reason was probably that there had so far been little experience in Indonesia with the sort of workouts and debt write-offs that were now needed. It was hoped that the stabilization of the economic situation would help remove or dilute those impediments. The intention of the Jakarta Initiative was to deal with the other problems mentioned.

Replying to a question from Mr. Ono on the INDRA scheme, the staff representative agreed that progress had been slower than expected, but the basic contract was in good shape and the staff was satisfied with its current condition. There were a few technical annexes still being finalized, but it was hoped that this would be completed soon so that the necessary documentation would be in place. However, the absence of that documentation at present did not constitute an impediment to the restructuring process. It would be important to complete the workouts through the Jakarta Initiative; after that, a decision would be made by corporations and their creditors whether to put these restructured debts through INDRA.

Mr. Eyzaguirre reiterated his surprise at the wording in the staff report relating to monetary policy and in particular to the use of the word "and" in the phrase describing the objective of monetary policy as influencing "exchange rate and inflation". There could be a situation in which the exchange rate would strengthen, while inflation did not subside immediately, because of lags or supply shocks, like the one stemming from problems in rice distribution. In a situation where the exchange rate strengthened but inflation did not subside, the appropriate monetary policy would be to ease, even if inflation did not show a clear downward trend.

Mr. Sobel wondered whether the funds put into the foreign exchange market came from foreign assistance or out of the country's own reserves and whether the amounts used for these interventions were announced before or retrospectively. He also wondered whether there should be any intervention into the foreign exchange market, given that the policy that seemed to have been agreed was to let the rupiah float.

The staff representative from the Policy Development and Review Department in reply to the question on the appropriateness of the monetary policy stance, said that monetary easing was the right approach in circumstances where the exchange rate was stabilizing but the rate of inflation remained high. However, in such a situation, one would probably ease more cautiously than one would if inflation was declining. Exaggerated monetary easing could encourage hoarding and switching wealth into particular commodities like rice.

There was a need to proceed more cautiously in situations in which inflation had not come down, the staff representative continued, even if the exchange rate had stabilized. If the exchange rate remained stable, inflation should come down rather rapidly. However, the inflation outcome for September in comparison to August might still be quite high because of carryover effects from the run-up in food prices during August.

Mr. Esdar, considering the problem of the appropriate monetary policy stance in the particular situation prevailing in Indonesia, regarded it as useful advice to rely on more than one indicator, given that the environment was not stable. While, in theory, an appropriate exchange rate anchor would temper inflation automatically, the same could not be said in an environment of unstable expectations. It was therefore crucial to look at inflation as well. The decision to ease should thus take into account various elements: the exchange rate, monetary policy, and the inflationary outlook. He wondered, however, whether it was sufficient to stabilize the exchange rate that was presently near 11,000 rupiah per dollar, or whether it was the objective to bring the exchange rate back to a level of about 10,000, which seemed to have been the basis of the program. The Board should therefore be cautious about indicating that stabilizing the exchange rate was sufficient. Instead, the Board should also make some comments as to the level at which stabilization was desirable.

The staff representative from the Policy Development and Review Department replied that the objective remained the stabilization of the exchange rate near a level of 10,000 rupiah per dollar.

On the question raised by Mr. Sobel concerning foreign exchange market interventions, the staff representative stated that those transactions were conducted with the country's own foreign reserves, because the financing of the budget deficit would pass from the government into the foreign exchange reserves of Bank Indonesia. That was however a steady process that was not aimed at influencing the exchange rate on a day-to-day basis. Rather, it was aimed at sterilizing deficit spending, and data showed that credit to the government had been going up in recent weeks as had been envisaged under the program. The intervention that had taken place was thus part of the basic architecture of the program. The government or Bank Indonesia had indicated publicly the precise mechanism involved and explained it to the markets. The rough amount used at an intervention that had already taken place was announced retrospectively, while no indications were given with respect to the amounts that would be involved in prospective interventions.

The Acting Chairman wondered whether it was accurate to say that the ongoing foreign exchange sales constituted the process by which foreign financing of the budget was taking place and that they were therefore not interventions trying to affect the exchange rate.

The staff representative from the Policy Development and Review Department confirmed the Acting Chairman's description of the process, confirming that these were essentially sales of the proceeds from the foreign financing of the budget. It was difficult, however, to make a clear distinction between foreign exchange market intervention and sales of budgetary proceeds, given that in was all done by Bank Indonesia. However, the way in which the procedure was being handled was perfectly consistent with sales of proceeds from financing the budget deficit in order to sterilize budgetary expenditure, as had been envisaged under the program.

Ms. Abdelati welcomed the staff's comprehensive responses and asked the staff to elaborate further on the support for families in need. The staff had said that the support would, for the time being, come from the rice targeting program and the employment creation program. She wondered if that meant that there was no further need for support to poor families or whether that was a matter for further review. She also wondered whether the staff representative's remark that exports might be weakening in coming months implied that the current account deficit targets would be shifted, or whether the lower exports would not impact the current account, as imports were also expected to decline.

The Director of the Asia and Pacific Department, replying to the question on support for poor families, stated that there was definitely further need to support poor families, but that, at the moment, the most immediate necessity was that the government concentrated its efforts on extending the targeted rice subsidy to all the families that were actually in need. The number of those families was large and the provision of support to all constituted a major challenge. Hence, at the moment, no other initiatives were planned.

The staff representative from the Legal Department, commenting on questions relating to corporate restructuring and bankruptcy, noted that one of the other reasons why corporate restructuring had not advanced recently were regulatory barriers. However, the authorities had been taking rather swift action in that direction. Most notably, there would soon be regulations issued that allowed for debt-for-equity conversions, thus removing what was considered to be a major obstacle.

It would also be one of the primary objectives of the task force, once it was operational, to facilitate the regulatory approval for restructuring, which, according to the private sector, was currently extremely complicated and gave rise to excessive delays, the staff representative said. It was therefore critical that the task force was operationalized as soon as possible. A World Bank technical assistance loan had been arranged for this purpose, and the matter was apparently on track.

On interim financing, the task force recognized that this was one of the critical issues in spurring the restructuring process, the staff representative stated. It would provide the incentives for companies to come forward and provide information. The task force was at present discussing with specialized foreign creditors, as well as the IFC, their involvement in providing financing on a senior basis in the context of restructuring. However, one of the concerns was weaknesses in the security law, i.e. the law on secured transactions that would give financing seniority to security interests over accounts receivables. The authorities would try to improve the secured transactions law as soon as possible.

If interim financing was the "carrot", bankruptcy law was the "stick", the staff representative continued, and it was important that the law be implemented effectively. With regard to the questions raised by Mr. Sobel and Ms. Lissakers on that issue, it was still rather early to pass judgement on the developments. It should be noted that there had not been many petitions filed so far. Creditors appeared to be adopting a wait-and-see attitude in order to assess whether the commercial court could effectively perform its job. Seven filings had been made so far, and the court appeared to be applying the time limits and criteria correctly on a procedural level. It was encouraging to see that, in several cases, the debtor had asked for a reorganization process under the law, which was proceeding. There were very specific time limits for such cases, and the handling of them should be regarded as encouraging because until now the bankruptcy law had been perceived as existing merely for company liquidation. It was therefore important that there was a change in the perception of the law and that it was also seen as a vehicle for company restructuring. This was a particularly useful way of binding in creditors in the context of the restructuring process.

Much work needed to be done in this area, especially if the volume of cases increased, the staff representative added. This would require continuous technical assistance. The Netherlands and Australia were providing important bilateral assistance, as was the Japanese Administered Account. One area that needed specific focus was the problem of the administrators who would be providing the day-to-day administration of the assets. There were concerns with regard to their physical safety, their fees, and the product liability insurance.

After adjourning at 1:02 p.m., the Board meeting reconvened at 2:30 p.m.

The staff representative from the World Bank made the following statement:

There are three areas on which the Bank was asked to comment that still have not been addressed. One was the question on possibilities for foreign participation in the banking system. A new amendment to the banking law is being prepared and has been proposed to parliament. It contains provisions that eliminate any restrictions on foreign banks [for listed companies??]. That is how things stand at the moment.

With regard to questions on the transparency and efficiency of the privatization process, it is known that there have been some problems recently in transactions involving two state enterprises. There are legitimate concerns in that respect and a privatization mission is addressing that in the field at this moment. There are two ways in which this problem can be approached. First, under our first adjustment loan, which is the policy reform support loan, PRSL, there is a condition for the release of the second tranche that refers to guidelines and regulations for the private provision of infrastructure, and that includes a process and transparency conditionality for the privatization of infrastructure. The staff is working with the authorities to get that guideline passed. That would bring about a considerable improvement for the transparency of the process of infrastructure privatization.

There are some concerns about the legal and regulatory and institutional framework with regard to the privatizations in the tradeable goods sectors. It is not entirely clear how that is progressing. Procedural rules for bidding still need to be worked out. The staff is currently working with the authorities on this matter, and that may require more comprehensive change to the legal framework. If that is the case, work on some interim measures will be required to provide a minimum of protection until a more robust legal and regulatory framework is in place.

When evaluating the transactions that are under way at the moment and the effect on them of the depressed economic conditions, it is useful to separate those transactions that the Indonesians are working on from those in which the Bank is helping them or which the Bank is pushing in the near term. Of the one dozen of companies involved, six are infrastructure enterprises for which bidding is relatively robust. Hence, if the regulation mentioned above can be passed as part of the second adjustment loan, that process can go ahead. The experience gained in Latin America with privatization of infrastructure during somewhat similar economic conditions will be helpful in this case. It appears that these transactions can go ahead, and there does not seem to be as much danger of problems in terms of depressed economic conditions as it might appear at first glance.

The other six privatizations in the tradeable goods sector still require further work on the corporate and legal side, as well as on the preparation of some interim procedures. The Bank is currently addressing these issues. One of the things that the Bank is looking at are claw-back procedures. These are transactions in which shares are privatized with the state retaining some nonvoting shares. In this way the state might be able to recoup some of the gain in asset value once economic conditions improve.

Experience has shown that in the long term only about 20 percent of the revenue gains that the state incurs in the context of privatization come from the sale of shares. Eighty percent of the overall revenue comes from dividends, in cases where the state continues to hold shares, and from increased tax revenues. Hence, the problem of the depressed share price at the moment may effectively not be as dramatic as it appears.

The major question remaining is how the rice targeting scheme is working at present and how it is to be expanded in the future. As Mr. Neiss has already said, the scheme is presently reaching about 4 million households, and the Government is trying to push this to about 17 million households by the end of the year. The targeting process that is being used is quite effective. It has been developed by Indonesia's successful family planning program which is called the BKKBN. It had in the past identified ways of delivering family planning services to poor households. Therefore, they had already in place a fully developed set of indicators, a set of targets, and a set of measures to identify poor households. Their system, administered through the health centers, was being used as the initial screening device to get the rice to the 4 million families which are presently reached by the scheme. It appears to be a system that has worked in the past at village and household level. The system is presently being expanded in order to move from the 4 million to the 17 million families. The aim is to include the near poor, using some modified indicators to separate the next tier of households. One of the aspects of the agricultural mission that is in the field at this moment is to work with the authorities on refining these indicators by bringing in some of the indicators that had been developed by [BOPANAS??], the planning agency, to identify the poor. The program still needs support in a number of areas: The rice being provided under the program is quality three rice, which is the lowest quality rice. The distribution system is so time-intensive, with long waiting times and other things which discourage people from collecting the rice provision given the potentially high opportunity cost involved for them. The

Bank has begun to work with NGOs and local officials to monitor the program and to obtain feedback from civil societies as to who is being reached and how it the program is working overall.

The price released by BULOGs at the moment is 80-85 percent of the market price. This difference from the market price seems to equate transport costs, and should therefore render smuggling unprofitable. This may thus be a price level at which BULOG can effectively release rice without giving rise to the problem that was raised by the Australian chair.

Mr. Taylor noted that the conclusion drawn by the staff representative from the World Bank would be correct, if the amount of rice being smuggled had already dominated the regional market. He wondered whether that had been the case, given that otherwise, if the regional market was large in relation to the amount being smuggled, the regional market could absorb much more rice at the price of 85 rupiah.

The staff representative from the World Bank replied that two days of Indonesian rice consumption was equivalent to one year's consumption in Singapore. With Thailand exporting and production having picked up in Vietnam, there was little reason to be concerned about the capacity of the regional markets to absorb rice.

Mr. Esdar, returning to a more general question, wondered whether there was not more in terms of previous experience in other countries on how to address an increase in food prices in a situation where the exchange rate was depreciating sharply. He asked whether it was not suboptimal to bring the products to the people given the scope for smuggling, the distribution and logistic problems, and whether it would not make more sense to provide food stamps or direct personal income subsidies, and leave the distribution to the market. He was doubtful that a public distribution system could be more efficient than one driven by demand and supply.

The staff representative from the World Bank replied that the Bank could consider other methods of income provision and income subsidy. The Bank's view at the moment was that there was a system in place in the villages that was able to identify and reach the poor families. That should be the basis to expand provisions from 4 million to 17 million households. Given that the existing identification system was working, the Bank had considered it appropriate to maintain it.

Referring to a question raised by Ms. Abdelati on other social programs, the staff representative said that the Bank was working with the authorities on income programs dealing with public works activities in rural areas, and using those labor-intensive programs as a way of income subsidization. The issue was being approached not only from the general income side, but also from the side of rice subsidies. Introducing a new system of food stamps at present would complicate a highly volatile situation at a point when the existing system appeared to be working.

Mr. Giustiniani wondered how the system of identifying poor families within a particular village worked and who was in charge of that process at the village level.

The staff representative from the World Bank clarified that there had been a system in existence that had developed through the village health centers, which themselves had initially been developed under the family planning program. That program identified poor households in Indonesia, and had developed a set of criteria such as measurements of housing quality, like concrete floors or dirt floors as indications of poverty. Because of the need for speed the Bank had used that existing system and its set of indicators, which were not all income-related, but captured socioeconomic characteristics of individual households. The program was administered through the health centers in the various villages that had very good data about actual conditions.

Mr. Giustiniani made the following statement:

At this stage of the discussion I would like to summarize my statement, which I will submit it for the record.

The economic and social situation in Indonesia remains difficult, though the outlook is much better than before. The task of the Indonesian authorities is already very hard, and it is made even more demanding by the uncertainty surrounding the economic and financial developments in the region as well as in the world economy as a whole. There are no clear indications that the economic outlook will improve in the short run. Against this background, the intention as expressed by the Indonesian authorities not to rely on the unilateral introduction of capital controls deserves the Board's support and appreciation.

The only choice for the Indonesian authorities to overcome the current crisis is to maintain a firm grip on financial policies, so as to restore domestic and international confidence in the rupiah and to press ahead with bold action on the structural fronts, especially banking and corporate sector restructuring, so as to lay the ground for an eventual economic recovery.

On monetary policy, we are still convinced that money matters and consequently we believe that the present situation calls for maintaining a tight and probably even a tighter monetary policy stance for the reasons that I explained in my previous intervention.

On fiscal policy, we note that uncertainties remain on the stance as well as on the feasibility and financial sustainability of crucial components of the fiscal policy conducted by the government. In this context, trying to reach 17 million households can hardly be described as targeting, and in addition, there are serious doubts concerning the practicability of the undertaking. I share most of the comments made on the matter by Mr. Taylor and Mr. Esdar.

On structural reforms, we share the concern expressed by other Directors on the delays and changes in the Government's privatization program, and we do not know whether or not this move represents an effective reversal of policy. However, it certainly contributes to increasing uncertainty on the direction of process.

As pointed out before, the economic and social situation remains difficult. Domestic confidence in the system of government is crucial for the cohesion of the country, for its economic recovery, and for the successful transition to a fully-fledged democracy. This requires the willingness of the Indonesian authorities to make hard decisions in the economic sphere. It will require political wisdom to distribute prudently the burden these decisions will bring with themselves. The task is not an easy one, but the international community stands ready to reward Indonesian efforts, as demonstrated by the recent agreement reached with the group of official creditors in Paris, and by the completion of this review of the program under the current Extended Arrangement. We wish the authorities well and every success in their endeavors.

Mr. Shields agreed with the comments made by Mr. Giustiniani about the authorities' resolve with regards to capital controls, given that their negative effects had been demonstrated by the market reaction on worries that controls might be introduced. With regard to exchange rate policy, it was right to maintain the current policy and not to move back to exchange rate bands, which could well present more difficulties for the authorities. He agreed strongly with Ms. Lissakers on the importance of addressing the issues of corruption and governance, as well as the U.S. chair's comments on fiscal policy and the social safety net.

On subsidies, Mr. Shields shared some of the reservations expressed by Mr. Aster and Mr. Taylor. Nevertheless, the current approach seemed to represent a great improvement compared to the previous one. The problems experienced with the blanket subsidy had reinforced his established position to such approaches. It was sad to see that so much of the assistance had ended up in the hands of traders rather than with the poor. It was also right to phase out most of the remaining subsidies.

Concerning fuel, Mr. Shields agreed with Mr. Sivaraman, and favored a reduction of the subsidy on premium gasoline. He asked the staff to comment on the feasibility of such a measure with regard to its impact on poverty and the potential political cost.

With regard to privatization, Mr. Shields felt reassured by the World Bank representative's statement.The aim should be to maintain the momentum for increased privatization, even though the domestic environment remained less than optimal.

The development of the Jakarta Initiative on corporate debt and banking restructuring should be welcomed, Mr. Shields remarked. It was important that companies recognized the costs of not engaging in the process, which consisted of the risk of bankruptcy. It was crucial that the banking law would be passed by parliament in October in order to allow IBRA and the asset management union to operate effectively, given that they would be major players in the corporate debt workout process.

In terms of tidying up operations for liquidity support, Mr. Shields urged the vigorous pursuit of these efforts in order to recover liquidity. Some companies were now cooperating with the arrangements, but major exceptions still remained, and those who violated regulations and had not provided compensation should be held responsible for their actions.

Mr. Shields also welcomed the completion of the Paris Club deal, which provided a solid foundation for budgetary planning for the following year.

Mr. Al-Turki made the following statement:

The Indonesian authorities are to be commended for their continued adherence to the economic program under very difficult circumstances. The economy's sharp contraction has exacerbated the problems of the corporate and banking sectors. If not reversed soon, public support for the program is likely to erode. Therefore, the main focus at this stage should be on accelerating the recovery. This will require strong and well-coordinated efforts by all concerned.

As most of the points I wanted to make have been raised by previous speakers, I will briefly address three issues for emphasis and submit my full statement for the record.

I remain of the view that restructuring corporate debt and providing companies with adequate financing are priorities. Reviving the corporate sector is essential for economic recovery, and would greatly facilitate the restructuring of the banking system. In this regard, I welcome the Jakarta initiative. The initiative appears to be well-balanced by giving both debtors and creditors incentives to reach a mutually beneficial agreement.

I fully endorse the steps taken to accelerate the pace of development spending. Fiscal stimuli are, indeed, needed in the current phase of the economic cycle. It is also critical to increase spending on strengthening the social safety net, especially in view of the rise in prices of basic foods.

The recent depreciation of the exchange rate makes it risky to reduce interest rates at this time. Therefore, it would be prudent to maintain a tight monetary stance for the time being. However, maintaining high interest rates for a prolonged period is not without cost. Therefore, it is important to monitor the situation closely with a view to reducing interest rates as soon as the exchange rate market strengthens.

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

Mr. Fernandez made the following statement:

I fully concur with the staff's appraisal and policy advice, and have little to add at this stage. I will, therefore, submit my full statement for the record and will limit myself to a few brief comments. The messages we would like to deliver to the Indonesian authorities are the following:

It is crucial to avoid any premature easing of interest rates, and to stick firmly to the intention not to resort to capital controls.

Fiscal policy needs to be allowed to play its supporting role as provided for in the program. In this regard, I would like to be sure that I understood correctly, what Mr. Neiss said this morning, that the forecast for the fiscal deficit of 8 .5 percent of GDP for the current year is maintained unchanged.

It is also imperative not to relax the banking restructuring process. I wonder whether the staff could provide additional information on the treatment of the 40 IBRA banks on which an audit had to be completed by the end of September.

The privatization program needs to get back on track as soon as possible.

Every effort needs to be made to keep the corporate debt restructuring process moving. The progress of private sector debt restructuring will also have a bearing on the coherence of the balance of payments forecasts. Any discrepancy would give the Indonesian authorities additional financial room of manoeuvre, which the Board would need to monitor closely. Accordingly, the next review should provide precise indications of payments actually realized by the private sector, and of their implications in terms of balance of payments needs.

Finally, like others, I welcome the recent Paris Club agreements, which provide an additional clear sign of support by the international community. In order to avoid any misunderstandings, it should be noted that the difference between creditor data and Indonesian data mentioned in the footnote of Supplement II has been entirely explained in the Paris Club by differences in exchange rate parameters.

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

Mr. Yakusha made the following statement:

We support the proposed decision. I fully share the staff's view that easing monetary policy at this juncture is premature and could risk a fall in the exchange rate with inflationary pressures resulting from that. Moreover, I believe the volatility in the exchange rate reveals how fragile market confidence still is. Hence, if Indonesia managed to stick to its tight monetary policy stance, I have no doubt that it will be rewarded with lower interest rates, just as Thailand and Korea were. As these countries have shown, however, it is essential to remain cautious and vigilant for a sustained period of time before these benefits can be reaped.

In the fiscal area, I encourage the authorities expeditiously to implement their development spending, particularly the initiatives on health, education, and employment creation.

Our main concern, however, continues to be focused on structural reforms. The staff report highlights the measures the authorities intend to take in bank restructuring, and which were announced on August 21st. The report also sets out in detail the intended functioning of the Jakarta initiative and the importance of the amendments to the banking law which is hoped to be passed. These are important measures and the Board welcomed them already at the last meeting. The staff report, however, has relatively few successes to show as regards the implementation of these structural measures. To some extent, this is understandable as the period between reviews is short. At the same time, however, it is somewhat worrying that we will today disburse almost SDR 700 million while there appears to have little in terms of visible results so far, especially with regard to structural reforms. Even the structural benchmarks which the program does include for the review have not been fully met. Given that the weight of the program has now shifted to the structural area, I believe there is a need to improve the monitoring of the progress being achieved. Certainly, after our experience with Russia, I believe there is an increased awareness of the danger of providing money on the basis of intentions in structural reforms rather than real progress, and we should be able to account for disbursements of funds, especially when it involves such large amounts and for a program where the focus is on structural reform. This poses real challenges on how we monitor progress and I have no easy answers how to solve this, especially when the relevant expertise is concentrated largely in the World Bank. In this light, I would like to support Mr. Taylor's view on the desirability of a paper, at least of a note to be made available from the Bank staff, which should perhaps cover not only the social issues and the rice market, but also provide some details on the implementation of other structural measures under the program. The Board should be fully informed on how much progress has been made and what more needs to be done in each area of structural reforms. Our message for the authorities is therefore that there is no room for relaxing their efforts on the structural front.

I note that the Jakarta principles may not include a clear time frame for debtors to come up with the restructuring plan and I realize that specific timetables are included in Indonesia bankruptcy procedures to which one can always revert if progress under the Jakarta principles is not satisfactory. Could the staff comment on the usefulness of including more specific deadlines in the Jakarta principles for corporate restructuring plans?

We welcome the authorities' firm and consistent indications that they have no intention of introducing capital controls. By doing so, they are demonstrating commendable discipline in pursuing sound macroeconomic policies, and this resolute stance will serve to enhance further confidence in Indonesia's policies and investment viabilities.

The Acting Chairman expressed concern with regard to the breadth of the request to the World Bank to prepare papers on the entire structural reform program. As the staff representative from the World Bank had said, there would be documents presented to the Board soon. He wondered therefore whether the Board could not limit the request somewhat and avoid asking for comprehensive papers.

Mr. Aster agreed with the Acting Chairman's statement on requests for papers from the Bank staff, and suggested that there was already some written material available in the Bank that could be compiled into the Fund's documentation. That might also help to streamline Board discussions.

Ms. Wang made the following statement:

The Indonesian authorities should be commended for their continuous efforts in implementing the program. It is encouraging to note that the rupiah has been strengthened somewhat since the beginning of July, although there was some relapse during this process, and the selling of foreign currency by the BI also played a role. I agree with the thrust of the staff's appraisal, and would like to concentrate on several points for emphasis.

First, on social stability. The reoccurrence of social unrest during the past month is really a cause of concern. As this chair has emphasized, social stability is the critical condition for economic stability and recovery. We strongly urge the authorities to take every effective measure to maintain social stability, and thus provide the essential basis for economic recovery. In this context, we welcome the newly announced Seven Point Strategy for Rice which is important in stabilizing prices. One of the seven measures is to extend the present coverage of the targeted subsidized rice supply of over 2 million households to at least 7.5 million poor families by October. However, according to press reports, there are about 17 million families now living below the official poverty line, and, obviously, more efforts need to be made to relieve the suffering of these families. In this regard, do the authorities have further plans to expand the coverage of the targeted subsidy program? Is it possible to distribute the subsidy in the form of a direct cash payment to poor families? In addition, we would like to join the staff in urging the authorities to increase their efforts to bring the fiscal balance and fiscal spending more closely into line with the program path, and give the stimulus to economic activity as programmed.

For banking restructuring, it seems that this process could be further accelerated with the passage of the banking law, allowing the transfer of assets to assets management units. We encourage the Parliament to pass this law as soon as possible. We welcome the announcement of the Jakarta Initiative, and are also pleased to learn that the market response to it is positive.

With these remarks, we support the proposed decision and the completion of the first review under the extended arrangement.

Mr. Careens made the following statement:

I am pleased to see that the Indonesian authorities are pressing ahead with policy implementation well in line with the economic program. Recent announcements of policy packages relating i.a to the banking sector, and the agreement in the Paris Club are factors that have contributed to a positive economic development and a strengthened exchange rate. Nevertheless, a sustainable change in market sentiment will require actual implementation. I would like to comment briefly on two of the areas where I find implementation is lagging somewhat.

First, the privatization process, a traditionally politically sensitive process, seems to be particularly problematic at this juncture. The unfavorable domestic as well as international environment depresses prices of assets and contributes to making investors cautious. As staff notes, the slowdown in privatization will entail foregone budget revenue, something that, in the current budget, fortunately will be compensated by savings on subsidies. What is more alarming, however, is that corporations that, in some cases are operating, inefficiently under government ownership, are in need of reform.

Furthermore, Indonesia's medium term budget outlook remains relatively weak, and the likelihood that investor sentiment towards emerging markets rapidly will swing around, is, in my view, relatively small. Bearing this in mind, the authorities should seek a careful balance between getting a good deal in the sale of public entities and the need for continued privatization.

Second, as regards bank sector restructuring, let me just emphasize that the ambitious package of bank restructuring measures announced in August should now be turned into action. Furthermore, I fully agree that it is critical to get an early approval of the amendments of the banking law. The provisional governing of the asset management unit of IBRA does not seem to be a satisfactory solution in the medium term.

Mr. Singh made the following statement:

Like other speakers, we are encouraged to note the progress that has recently been achieved in the implementation of the program and the slow return of market confidence. But, as it was already pointed out several times, the Indonesian economic and social situation remains very fragile. It is, therefore, important that the authorities pursue their efforts to follow the appropriate policy mix and carry through the urgently needed structural reforms.

With respect to macroeconomic policy, we agree that fiscal policy should provide some stimulus and would, therefore, encourage the authorities to accelerate the pace of development spending. Monetary policy, by contrast, should remain tight in order to stabilize the rupiah and reduce inflation. The tightening of monetary policy in August which reduced the excess of base money over its indicative target was correct. Only when a substantial reduction in inflation and a sustained appreciation of the rupiah have been achieved, will an easing of monetary policy be appropriate. Moreover, we fully support the draft law instituting Bank Indonesia's autonomy.

On the structural front, food security should rank high on the authorities' priority list. However, general subsidies on food have become quite ineffective as a measure to protect the poor. Despite subsidies, the item most important to poor families, namely low quality rice, has undergone a sharp price increase since last April. We welcome, therefore, the elimination of these subsidies and the adoption of a more targeted system. All efforts should now be directed at improving the targeted distribution of subsidized rice to poor families.

We also support the temporary exemption of VAT for rice and other essential items. As this measure amounts to a sort of subsidy, we would encourage the authorities to adopt a rather narrow definition of "essential items" and keep to the temporary nature of this exemption. The liberalization of the import and distribution of food is also welcome. This step, together with the reduction of BULOG's monopoly, will improve the efficiency of the distribution system and limit price increases.

Progress on bank restructuring has been modest. Delays have arisen with respect to the sale of audited banks or to the issuance of government bonds and the auditing of IBRA banks and major non-IBRA banks by international firms was only partially concluded. The restructuring of the banking sector is essential for economic recovery, the pace of reform should therefore be accelerated. The approval by Parliament of the necessary amendments to the banking law will be particularly crucial for this process. We would like to urge the authorities to make every effort to ensure these amendments are passed promptly. We also welcome the next MAE mission, which should serve as a catalyst to ensure that progress in bank restructuring is maintained or accelerated. We expect that this mission will provide us with a progress report showing achievements since the start of the program, that could serve as a basis for discussion at the time of our next review.

An orderly restructuring of corporate sector debt is also a prerequisite for the resumption of growth and employment. But in this area too, progress has until now been slow. We welcome, therefore, the newly established Jakarta-Initiative providing a sophisticated framework for fostering out-of-court debt-workouts.

The efforts of the Task Force to remove regulatory obstacles will be particularly useful, especially regarding changes to provide for tax neutrality of mergers and to eliminate restrictions on debt for equity swaps. Together with the new bankruptcy legislation, the Jakarta-Initiative should provide the right incentives to allow progress on debt restructuring. Without the threat of bankruptcy to induce debtors to become involved in negotiations, the whole Initiative could be ineffective, as corporations could continue not paying either interest nor principal without any sanction.

This being said, we agree to conclude the first review under the extended arrangement and wish the authorities every success in their endeavor.

The Director of the Asia and Pacific Department, taking up comments made by Mr. Shields and in Ms. Lissakers' preliminary statement on the issue of governance, stated that the economic program was combating corruption and other contraventions against governance in an indirect way, by dismantling monopolies. Allowing private food imports, for example, would do a lot to curb corruption in BULOG. The second way of improving governance contained in the program was through audits of various institutions, BULOG, Pertamina, the electrical company, and the reforestation fund. That would provide the basis for improved governance and decreased corruption. Thirdly, governance was being improved by reducing the distribution of special government privileges to certain industries and companies, in the form of tax exemptions as well as by redirecting credit from state enterprises. In addition, the World Bank was tackling the problem of governance directly.

The subsidies on fuel, which had been in place longer than the subsidies on food, could not be kept indefinitely, the Director continued. The government was already looking at ways and means to start the reduction of these subsidies. Aviation fuel would already be desubsidized; premium gasoline was under consideration. One should remember, however, that the increase in gasoline prices had been one of the reasons for the initial civil unrest that began in Medan, hence, some caution would be necessary. This could be combined with some targeted operation. The same was true for electricity, where there were plans for reducing the subsidies, combined with targeting for electricity provision to the poorer sections of the population.

The deficit forecast for the current fiscal year ending in March 1999 was 8.5 percent of GDP and was still valid, the Director confirmed. The issue was to translate that forecast into reality. That was not a matter of admonishing the authorities, as they were fully aware of the need, but rather a matter of helping at the microlevel the officials responsible for the releases and for starting new programs, in particular the employment creating programs. The aim was to ensure that these releases were actually made in an orderly way and that the programs could start quickly.

Several speakers had emphasized the need to keep monetary policy tight and to guard against a premature decrease in interest rates, which was exactly the message that was being given to the authorities, the Director continued. The revised program did not include a revision of the monetary targets, because the staff did not think the time had come yet to make any changes. Eventually, interest rates would have to come down. In that case, the staff would follow the strategy that Korea and Thailand had applied, which had consisted in carefully monitoring the rate of inflation and the exchange rate. As inflation came down, the exchange market would stabilize, and the rate would appreciate. Once that happened, the authorities would cautiously reduce interest rates or allow them to come down, while always remaining alert and ready to tighten, should financial markets developments require that. That strategy had worked well in both Thailand and Korea, and the staff hoped it would also work in Indonesia. However, it was difficult to say when the time would come to begin monetary easing.

He could not agree with comments made by Mr. Yakusha that structural measures had not been sufficient, the Director said, and stressed that structural efforts were currently concentrated on financial sector reform. In this area, important steps had been taken, were still continuing, and further steps were planned for the near future. The next area of concentration would be corporate restructuring. In addition to that, various other structural efforts were ongoing, for example deregulation measures. The staff therefore did not think that the structural measures taken so far had been insufficient.

On the monitoring of structural measures, the Director remarked that the staff was ensuring the effective monitoring by disaggregating each structural measure into precisely defined submeasures with a clear timing attached for implementation. The results were the matrixes that both the World Bank and the Fund had constructed and were revising every month. These matrixes were attached to the letter of intent each month. They were the best means available to monitor and keep track of the implementation status of structural measures.

The staff representative from the Policy Development and Review Department, in response to a question by Mr. Fernández on the status of the audits of IBRA banks, reported that the audits of seven large IBRA banks had been completed in June. The audits of 15 non- IBRA banks had also been completed recently. The audits of the remaining 46 IBRA banks referred to by Mr. Fernández were expected to begin within the next days, and were scheduled to be completed by the end of October. The audits of the remaining non-IBRA banks, which were being conducted under the auspices of the ADB, would start in the coming days and should be completed by end-October as well. However, that might be somewhat ambitious given the large number.

With regard to the question from Mr. Yakusha on the usefulness of specific deadlines as part of the Jakarta Initiative, the staff representative said that those had not been included at this stage, but it had not been precluded to have them introduced at a later stage. The Jakarta Initiative, as it had been set out when it was announced recently, was general, and made provisions for more specific guidelines to be introduced at a later stage. If it were deemed useful and if it seemed that progress was not being made sufficiently fast, serious consideration would be given to introducing specific deadlines later on.

Mr. Zamani made the following concluding statement:

I would like to emphasize to the Board that parliament has so far passed the legislation required for the program. Some delays may have been encountered at times, but as far as the legislation is concerned that Directors have mentioned today as required to be passed on banking, the discussions in parliament have been proceeding, and I expect that the respective bills will be approved soon.

Given the past track record, the Board may chose not to put a deadline on parliament, but may urge it that the laws mentioned in today's discussion need to be passed in order for the program to move forward.

I would like to thank Directors and management of the Fund for the approval of the Indonesian adjustment program. Although much remains to be done, as well as to be accelerated, as mentioned by Directors, at least there have been more encouraging signs in the last review. The rice program has been put in place, with prospects that the situation will improve further. The rupiah has, to some extent, regained some of the ground lost earlier, and bank restructuring has progressed. But my authorities are not complacent, and have remained resolute about re-establishing greater stability and restoring full market confidence as expeditiously as possible by adhering to the Fund's programs as well as to those of the World Bank.

In the near future, we expect to see a more promising outlook on all fronts. Let me assure Directors that your advice and concerns will be given the highest attention and priority by the authorities. This will include the widespread concern expressed here today over the food situation and the overall efficiency and efficacy of the programs related to the social safety net. Of course, the fiscal, monetary, and structural reform programs will also continue to be emphasized.

In conclusion, I would like to thank the management and the staff of the Fund for their hard work and dedication and for standing head and shoulders with the authorities in striving to restore economic and financial stability in Indonesia. In particular, I would like to make special mention of thanks to all Fund and Bank staff who have been involved in the program with Indonesia for about one year now. As Directors could well observe, the way in which the staff has addressed the queries of Directors indicates that the staff has been fully engaged in the required measures.

I would also like to express our appreciation to all those who have been involved and have contributed in any way to the success of the Paris Club negotiations. I am hopeful that the international community will continue to lend support to Indonesia, without which the adjustment and reform efforts cannot move forward at the speed that we should like Indonesia to proceed.

The Executive Board took the following decision:

1. Indonesia has consulted with the Fund in accordance with paragraph 3(c) of the Extended Arrangement for Indonesia (EBS/98/130, Sup. 3, 8/27/98).

2. The letter dated September 11, 1998 from the State Coordinating Minister for Economy, Finance, and Industry, with the attached memorandum of Economic and Financial Policies shall be annexed to the Extended Arrangement, and the letter dated July 29, 1998 from the State Coordinating Minister for Economy, Finance, and Industry, and the memorandum attached thereto, shall be supplemented and modified by the letter dated September 11, 1998 (with its attached memorandum).

3. The Fund decides that the first review contemplated in paragraph 3(c) of the Extended Arrangement for Indonesia is completed and that Indonesia may continue to make purchases in accordance with the provisions of the Extended Arrangement.

Decision No. 11808-(98/104), adopted
September 25, 1998

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/98/103 (9/24/98) and EBM/98/104 (9/25/98).

4. ARAB REPUBLIC OF EGYPT—STAND-BY ARRANGEMENT—REVIEW, AND WAIVER OF PERFORMANCE CRITERIA

The Arab Republic of Egypt has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for the Arab Republic of Egypt (EBS/96/149, Sup. 2, 10/16/96), as amended, and Appendix I of the Memorandum of Economic Policy attached to the letter from the Minister of Public Sector, Administrative Development, and Environment, the Minister of Finance, and the Governor of the Central Bank of Egypt, dated September 12, 1996, in order to review performance under the program supported by the Stand-By Arrangement.

The Fund decides that the seventh and final review contemplated in paragraph 3(c) of the Stand-By Arrangement is completed and that, notwithstanding the nonobservance of the performance criteria set forth in paragraphs 3(a)(ii), 3(a)(iii), 3(a)(iv), and 3(b)(iii) of the Stand-By Arrangement, the Arab Republic of Egypt may proceed to make purchases in accordance with the provisions of the Stand-By Arrangement.

Decision No. 11809-(98/104), adopted
September 25, 1998

5. RELATIONS WITH WORLD TRADE ORGANIZATION—CONSULTATION WITH WTO COMMITTEE ON BALANCE OF PAYMENTS RESTRICTIONS—FUND GUIDANCE

The Executive Board approves the recommendation with regard to the guidance statement for the Fund representative attending the consultation of the WTO Committee on Balance of Payments Restrictions with Bulgaria, as set forth in EBD/98/96 (9/21/8).

Decision No. 11810-(98/104), adopted
September 23, 1998

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/98/158 (9/22/98) and EBAM/98/160 (9/22/98), by Advisors to Executive Directors as set forth in EBAM/98/158 (9/22/98) and EBAM/98/159 (9/22/98), and by Assistants to Executive Directors as set forth in EBAM/98/158 (9/22/98) and EBAM/98/159 (9/22/98) is approved.

APPROVED: March 26, 2001

SHAILENDRA J. ANJARIA
Secretary