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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/129

9:30 a.m., December 21, 2000

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

H. Köhler, Chairman
S. Fischer, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
S.M. Al-Turki	A.S. Al Azzaz, Temporary
A. Barro Chambrier	D. Ondo Mañe
T.A. Bernes	P. Charleton
	P.R. Fenton, Temporary
	P.H. Whitehall, Temporary
M.J. Callaghan	W.C. Mañalac, Temporary
R.F. Cippà	B. Siegenthaler, Temporary
	T. Skurzewski, Temporary
B. Esdar	F. Haupt, Temporary
	R. von Kleist, Temporary
R. Faini	H. Vittas
	J.N. Santos, Temporary
	G. De Blasio, Temporary
	C.A.E. Sdralevich, Temporary
D.I. Djojosobroto	H.E. Phang, Temporary
	N. Jadhav, Temporray
W. Kiekens	S. Zádor, Temporary
	A. Jacoby, Temporary
O.-P. Lehmussaari	T. Elkjaer, Temporary
	J. Sigurgeirsson, Temporary
K. Lissakers	J.M. Abbott, Temporary
	L. Redifer, Temporary
	G. Bauche
	S. Boucher, Temporary
A. Mirakhor	M. Daïri
	S. Rouai, Temporary
	A. Lushin
	L. Palei, Temporary
	F. Varela
S. Pickford	S.P. Collins
	B. Kelmanson, Temporary
	R. Junguito
	M. Yépez, Temporary
C.D.R. Rustomjee	
A.S. Shaalan	
Wei Benhua	Liu F., Temporary
J. de Beaufort Wijnholds	I.C. Ioannou, Temporary
Y. Yoshimura	
	G.R. Le Fort
	D. Vogel, Temporary

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary
A. Mountford, Acting Secretary
C.E.L. Andersen, Assistant
P. Cirillo, Assistant
S. Soromenho-Ramos, Assistant

Malawi—2000 Article IV Consultation; Poverty Reduction and Growth Facility—Three-Year Arrangement; Interim Poverty Reduction Strategy Paper and Joint Staff Assessment; and Enhanced Initiative for Heavily Indebted Poor Countries—Decision Point
Staff representatives: Shields, AFR; Ahmed, PDR
Turkey—Stand-By Arrangement—Review, and Modification of Performance Criteria; and Supplemental Reserve Facility
Staff representatives: Deppler, EU1; Cottarelli, EU1; Ingves, MAE; Seade, PDR
Madagascar—Enhanced Initiative for Heavily Indebted Poor Countries—Decision Point; and Interim Poverty Reduction Strategy Paper and Joint Staff Assessment
Staff representatives: Sacerdoti, AFR; Seade, PDR
Cameroon—Poverty Reduction and Growth Facility—Three-Year Arrangement
Staff representatives: Katz, AFR; Ahmed, PDR

Also Present
IBRD: J.S. Hentschel, B. Horton, J.A. Katz, R.B Liebenthal, D. Mans, and H. Zaman, Africa Regional Office; K.B. McCollom and J. Parks, Europe and Central Asia Regional Office; Y.C. Kim, HIPC Office. African Department: G.E. Gondwe, Director; E. Hernández-Catá, Associate Director; P.A. Acquah, Deputy Director; A. Basu, Deputy Director; J. Fajgenbaum, Deputy Director; T.S. Alleyne, U. Bartsch, K.J. Cady, J.A.P. Clément, G.Z. El-Masry, M.T. Hadjimichael, A. Kammer, M. Katz, A.C. Kouwenaar, E.G. Kpodar, C.A. Leite, J. Mathiesen, C.J. McAuliffe, A.M. McCaul, M. Nowak, M. Odedokun, D.C. Ross, E. Sacertodi, D. Sakho, J.H. Shields, A. Tahari, I. Thiam. European I Department: M.C. Deppler, Director; J.R. Artus, Deputy Director; S.M. Schadler, Deputy Director; B.J. Aitken, C. Cottarelli, T. Krueger, R. Moalla-Fetini, C.E. Pinerua. External Relations Department: T.C. Dawson, Director; C.N. Lotze, W.J. Murray, J.H. Wolff. Fiscal Affairs Department: T. Baunsgaard, J.A. Brumby, J. Fournel, E.A. Mottu, C. Schiller, R.J. Singh. Legal Department: B.D. Dimitrachkov, H. Elizalde, S. Hagan, N.S. Kyraikos-Saad, T.W.M. Laryea, D.E. Siegel. Monetary and Exchange Affairs Department: S. Ingves, Director; T.J.T. Baliño, D. Hoelscher, M.A. Josefsson, M.G. Zephirin. Policy Development and Review Department: J.T. Boorman, Director; M. Ahmed, Deputy Director; G.C. Anayiotis, C.C. Delechat, M. Fisher, C.H. Lim, A.T. McArthur, D.G. McGettigan, M.P. Mlachila, A.G. Santos, H. Tadesse, J. Seade. Research Department: M. Mussa, Economic Counsellor and Director; S.V. Eble, K.M. Kletzer. Secretary's Department: S. Bhatia, L. Hubloue, A. Mountford. Treasurer's Department: B.S. Newman, Deputy Treasurer. Office of the Managing Director: A.A.E. Bertuch-Samuels, Special Advisor; C. Salmon, Personal Assistant; S.B. Brown. Advisors to Executive Directors: M.A. Ahmed, E. Azoulay, M. Beauregard, M.P. Bhatta, S. Çakır, J.A. Chelsky, V. de los Santos, S.S. Farid, N. Guetat, A.R. Ismael, J.M. Jones, M.F. Melhem, J. Ntamatungiro, C.-P. Schollmeier, I. Steinbuka, J.R. Suárez, S. Thiam, M. Yanase. Assistants to Executive Directors: S.A. Bakhache, V. Bhaskar, J.G. Borpujari, , P.A. Brukoff, G.M. Campos, I.- K. Cho, T. Hadded, K. Harada, M.S. Hililan, C. Josz, S.K. Keshava, E. Kornitch, K. Kpetigo, J.K. Kwakye, Liu Z., A. Maciá, J. Mafararikwa, R. Maino, R. Manivat, T. May, J.A.K. Munthali, P.A. Nijsse, E. Nyambal, L. Ocampos, K. Ongley, U.F. Seyidzade, Sugeng, A. Sutt, Tong Y., M. Walsh, I. Zakharchenkov.

1. MALAWI—2000 ARTICLE IV CONSULTATION; POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT; INTERIM POVERTY REDUCTION STRATEGY PAPER AND JOINT STAFF ASSESSMENT; AND ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—DECISION POINT

The Executive Directors considered the staff report for the 2000 Article IV consultation with Malawi and its request for a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) (EBS/00/263, 12/11/00; and Cor. 1, 12/20/00), together with a paper, prepared jointly by the staffs of the Fund and the International Development Association, on the decision point document for Malawi under the enhanced Initiative for HIPC (EBS/00/260, 12/7/00; Cor. 1, 12/20/00; and Sup. 1, 12/20/00). They had before them an interim poverty reduction strategy paper for Malawi (EBD/00/117, 12/7/00) and an assessment of the interim poverty reduction strategy paper, prepared jointly by the staffs of the Fund and the International Development Association (EBD/00/116, 12/7/00). They also had before a background paper on selected issues in Malawi and statistical appendix (SM/00/281, 12/15/00).

The staff representative from the African Department submitted the following statement:

> Since the staff report (EBS/00/263, 12/11/00) and the HIPC decision point document (EBS/00/260, 12/7/00) were issued, several developments have occurred. They do not alter the thrust of the staff appraisal.
>
> All prior actions have now been fulfilled:
>
> A FAD mission has confirmed that line ministries are maintaining commitment registers and submitting monthly reports on commitments and arrears to the Ministry of Finance. However, coverage so far is incomplete and quality is mixed.
>
> The Minister of Finance and Economic Planning has established a loans review committee, which will, among other things, provide guidance in the management of public debt; it will hold its first meeting on December 22.
>
> The bill to extend the surtax base to wholesale and retail stages was submitted to parliament on December 15.
>
> Staff has received additional information regarding inflation, fiscal and monetary developments as follows:
>
> The 12-month CPI inflation remained at 35 percent in November.
>
> Preliminary figures for the net domestic financing of the central government in the first quarter of the fiscal year (July-June) were slightly above projections.

The level of reserve money at end-November was above target. In response, the central bank has recently stepped up the pace of open-market operations; treasury bill auctions are now being conducted every week rather than once every two weeks and yields on three-month treasury bills have risen to 42 percent from 34 percent in early November. Nevertheless, there is a risk that a small overrun on the reserve money target for the October-December quarter may occur since it is based on an average of monthly figures.

On December 13, 2000, the Paris Club agreed in principle to a flow rescheduling on Cologne terms. Creditors also agreed to change the cutoff date to January 1, 1997, with the consequence that all Paris Club debt is now classified as pre-cutoff date debt. The Paris Club creditors noted that, with Japan's policy of reimbursing all debt service paid to them by Malawi, actual debt service payments to Paris Club creditors would be effectively reduced to zero. The Paris Club is expected to meet to discuss the rescheduling for Malawi in January 2001.

Mr. Rustomjee submitted the following statement:

Let me begin by expressing the appreciation of my Malawian authorities to the Executive Board, management and staff as well as the donor community for continued support as they seek to alleviate widespread poverty in the country. The outcome of this meeting on possible assistance by the Fund under the PRGF and debt relief under the enhanced HIPC Initiative is being awaited with eagerness. The authorities are keenly aware that the program now underway provides an important reference point in their intensified efforts to address the formidable challenges that confront the economy. They wish to acknowledge the cooperation they have been receiving from management and staff in designing and formulating their program; the staff has been tireless in working to produce a set of very candid papers.

At the outset, the Malawian authorities wish to underscore the importance they attach to the steadfast implementation of bold policies and comprehensive economic adjustment and reform measures, which will be essential in restoring macroeconomic stability; promoting efficiency and growth; and reducing widespread poverty. They are hopeful that with their firm commitment to the pursuit of all the policies outlined in their Memorandum of Economic Policies and the Interim Poverty Reduction Strategy Paper (Interim PRSP), Malawi will be able to earn the confidence of the donor community to press ahead with more aggressive poverty reduction efforts.

Malawi is a small landlocked country that remains one of the poorest in the world, with very weak social indicators: a very low per capita income ($163 in 1999), a low and declining life expectancy (42 years) and a very high

infant mortality rate (134 per thousand births). Over the years, several attempts have been made to introduce economic reforms with the support of the Fund and the World Bank to promote broad-based growth. Since the 1980s progress has been made towards improving the environment for private-sector investment and growth. However, the authorities are increasingly aware that the attainment of strong and sustainable growth has been elusive, reflecting the convergence of a number of adverse factors, including in particular, unfavorable weather conditions, a secular decline in the terms of trade, the high incidence of HIV/AIDs, and slippages in policy implementation.

In the circumstances, economic performance has been mixed and growth has been modest, leading to a low growth in per capita income. Real per capita GDP growth averaged about ½ percent between 1989 and 1999. In the last five years (1995-1999) renewed attempts were made in the context of a Fund-supported program under the Enhanced Structural Adjustment Facility (ESAF). During this period, growth strengthened, albeit still mixed and moderate. Real GDP is expected to rise to 3.2 percent in 2000. The rate of inflation subsided substantially, although pressures intensified at mid-2000, reflecting mainly the sharp depreciation of the exchange rate and the weakening of policies. More significantly, notable steps were taken to introduce structural reforms with a view to promoting economic efficiency. In this connection, a number of public sector enterprises were brought to the point of sale at the end of 1999 in order to enhance the role of the private sector.

Furthermore, interest rates have been decontrolled since 1993 and the foreign exchange system has been liberalized. To improve financial intermediation, two foreign banks and a discount house have already established operations, while the government is taking steps to reduce its holding in the two major commercial banks. Following the introduction of substantial trade reforms, Malawi now maintains a very liberal trade regime, with the IMF index of restrictiveness estimated at 3 and compares favorably with other developing countries.

Notwithstanding the achievements of deregulating the economy, Malawi continues to face the formidable tasks of restoring and sustaining macroeconomic stability. Putting the economy on a path of higher growth would be the basis for a substantial and lasting reduction in poverty. Some studies at the World Bank have estimated that Malawi needs to generate a minimum of a 5.3 percent real annual rate of growth in output in order to prevent the number of the poor from increasing. This is a difficult challenge to overcome , particularly, when the HIV/AIDs pandemic threatens to weaken the very foundations upon which further progress is predicated. It is estimated that 7 percent of the population, mainly those in the working age group, are

affected and the disease will significantly lower productivity, reduce private savings and increase public spending.

While attempting to restore macroeconomic stability, the authorities also realize the urgent need to boost savings and investment rates, to reinforce fiscal discipline as the key to reducing monetary expansion and interest rates, to foster competition in the real sector and to reduce existing monopolies. Land reform is also considered to be a key element in poverty reduction. The enforcement of accountability and improved governance is being pursued vigorously as an important element in increasing transparency in public finances.

Against the backdrop of these daunting challenges, the authorities have adopted an economic adjustment and reform program that has been cast in a medium-term framework. Real GDP growth will accelerate to about 4.5 percent, the rate of inflation will be reduced to 5 percent and international reserves will increase to 4.5 months of imports of goods and nonfactorservices. The number of people under the poverty line will be progressively reduced.

At the same time, structural reforms will be broadened and deepened. The expenditure control and monitoring system is being improved and strengthened; the medium-term expenditure framework (MTEF) will be broadened and applied to prioritize government recurrent outlays; the Malawi Revenue Authority (MRA) will be strengthened to bolster revenue collection; civil service and financial sector reforms will be continued with the prospective privatization of commercial banks and the strengthening of the regulatory framework. The strengthening of relevant democratic oversight institutions including the Anti-Corruption Bureau (ACB), the Public Accounts Committee, the Public Prosecutor's Office and the Auditor General's Office, will be pursued as crucial components of the authorities' strategy in improving accountability and governance.

The Interim PRSP presents a detailed analysis of poverty in Malawi and constitutes a credible road map for effective utilization of debt relief resources. The formulation of this document has not only benefited from a process of consultation with a broad cross-section of the Malawian society and donors but also from a wealth of work already completed, including the Vision 2020 whose growth scenarios were recently calibrated by the National Economic Council, the Policy Analysis Initiative spearheaded by the Office of the Vice President, the National Strategic Framework for HIV/AIDs, the Public Expenditure Review and the MTEF Review both initiated by the Ministry of Finance. The authorities have acknowledged that gaps in the document remain to be filled in order to formulate a robust Poverty Reduction Strategy Paper (PRSP). They are also expecting to take into account the comments that will be made in the Board as they articulate their document.

Meanwhile, a three-pronged approach has been adopted for growth and poverty reduction, focusing on interventions in the agricultural sector that directly target the poor, restoring macroeconomic stability, as well as increasing investment in social sectors and human capital. The timetable for completion of this exercise shows that the PRSP will continue to be developed in a participatory manner, involving local and district authorities, traditional authorities, the NGOs, parliament and the donor community.

The macroeconomic objectives for the near term are to achieve a growth rate of about 3.0 percent, reduce the rate of inflation to 10 percent by December 2001, bring the current account balance of payments deficit to 7.7 percent of GDP and increase gross external reserves to the equivalent of 4.7 months of imports by the end of 2001. To achieve these objectives, the authorities will vigorously pursue firm financial policies with monetary policy actions focused on reducing the rate of inflation, consistent with the balance of payments objective. Accordingly, the open market operations in Reserve Bank of Malawi and treasury bills are being actively utilized to mop up excess liquidity and to bring money supply in line with program targets. The reserve requirement on domestic currency deposits has been reduced with the intention of lowering it further when liquidity conditions permit. Thus far, the authorities have indicated that the program remains broadly on track. The exchange rate of the kwacha is market determined and any interventions will be restricted to the achievement of the external reserve target and smoothing sudden substantial movements.

The implementation of a tight fiscal policy stance remains the centerpiece of the program. It is intended to rapidly restore fiscal discipline, initiated by the ten-point plan, which was enunciated when the new Minister of Finance was appointed earlier in the year. For the fiscal year 2000-01, the overall cash budget deficit will be limited to 11.4 percent of GDP, with the domestic budget deficit amounting only 1.3 percent of GDP. This will be achieved through adherence to the budget projections on wages and salaries, which allows for a general increase, the implementation of a new housing allowance scheme and the introduction of contractual employment for top civil servants. The intention is to effect a decompression of the wage scale. At the same time, ministers and members of parliament will receive the same treatment as the majority of civil servants who are not on contract. Nonpriority expenditure has been curtailed in favor of antipoverty programs so that outlays on social sectors will increase relative to GDP. Cost recovery measures on administrative and public services have been adopted, while spending on utilities are being closely monitored; the cost of internal and external travel has been curtailed while the cost of representation abroad is being reviewed. Perhaps more significantly a new expenditure and control system has been put in place with the assistance of the Fund and should help to improve overall expenditure management and to avoid the recurrence of domestic arrears which became subject of the management's report on

noncompliant purchase and which was considered by the Board in August. Meanwhile, revenue performance will be strengthened through continued improvement in tax administration and through appropriate incentives given to MRA.

As already indicated structural reforms will be widened and deepened through the introduction of a wide range of measures that include the further liberalization of trade in agricultural products coupled with the expansion of private sector involvement. Meanwhile, steps are being taken to commercialize the Agricultural Development and Marketing Corporation (ADMARC) in anticipation of its full privatization in 2002. The National Food Reserve Agency is being reformed and recapitalized with the assistance of the international donors. The production of tobacco has been liberalized with smallholders production expanding substantially in recent years. The role of Intermediate Buyers is being redefined to ensure that quality is not compromised. Financial sector reforms will focus on the privatization of the two main commercial banks while completing an action plan for the introduction of a new and comprehensive regulatory framework early in the new year.

In the area of governance, the focus is on combating corruption and fraud, especially in the light of the recent incidents that were unearthed by Public Accounts Committee and the Auditor General. Accordingly, the government has stepped up its assistance to the work of the democratic oversight institutions, including the Anti-Corruption Bureau. All previous cases of corruption and fraud will be pursued diligently by mounting careful investigations and prosecuting the officials involved. The Public Accounts Committee has released its report and introduced it for debate in parliament this week. Meanwhile legislation will be tightened to improve safeguards against corruption, while a new Procurement Code and Procurement Authority will be established to decentralize and bring about transparency in the procedures to be followed by purchasing agencies.

In order to reduce income inequality and poverty, the government in consultation with civil society and with technical assistance from the World Bank has formulated a National Safety Net Strategy, focusing on low-income households to ensure food security. To this end, a “starter pack” program involving the distribution of seeds and fertilizer inputs has being refined to better target the poor.

The debt sustainability assistance has confirmed what the authorities have known all along, that Malawi’s debt is high and unsustainable. My authorities therefore welcome the efforts of the international community to respond positively to their request for debt relief assistance that would allow them to take a more aggressive approach to poverty reduction initiatives. As already indicated, the authorities are aware of the remaining gaps in their

Interim PRSP and have set out a realistic timetable in which a more robust document could be produced through a more intensified process of consultation with civil society. The Decision Point Document has presented carefully articulated triggers, which the authorities view as appropriate in order to satisfy the floating Completion Point. My authorities believe that the proposed interim assistance is consistent with the provisions of the HIPC Initiative.

Malawi has a long history of commitment to economic adjustment and reform and the reduction of poverty, supported by the Fund, the World Bank and the donor community. There has been appreciable progress along the way, with a much-improved environment for the development of the private sector. The current program is a further attempt to bring the process of reform and adjustment forward as basis for poverty reduction. A reasonable track record has already been established with the implementation of the previous three-year program under ESAF, albeit with the difficulties that required waivers. The current program holds promise given the commitment and renewed vigor expressed by the authorities in their ten-point plan.

In the light of the foregoing, I request approval for Fund assistance to Malawi under the PRGF and debt relief under the enhanced HIPC Initiative. The NPV of debt-to exports ratio will remain high above the threshold of 150 percent. It will be important to keep the case under close review with a view to reassessing the amount of assistance to Malawi at the Completion Point.

Mr. Ondo Mane submitted the following statement:

As stressed by Mr. Rustomjee in his comprehensive preliminary report statement, Malawi is one of the poorest countries in the world, with very weak social indicators. The country faces a number of constraints, which have limited the development of its economic potential. In particular, the low literacy rate and the high mortality rates have led to low productivity and growth, particularly in the agricultural sector, where the poorest households are concentrated. Moreover, the policies pursued before 1994 in the context of a state-command economy did not promote the development of a dynamic private sector. Following the establishment of democracy in 1994, the Malawi authorities undertook far-reaching reforms in the context of an ESAF-supported program, with a view to reducing state controls and promoting market-based growth. The program also aimed at improving government finances, a key factor for macroeconomic stability. On the structural front, progress was made in liberalizing agricultural activities, and regulating the financial sector.

The response to the authorities' reform efforts was generally positive, as evidenced by the return of growth, following a long period of economic

stagnation, a lowering of inflation, and a reduction of the overall fiscal deficit. However, despite these improvements, real GDP growth has been too low to have a significant impact on poverty, which remains widespread. The achieved real growth rate barely covered the population growth, and did not generate adequate savings for the needed investment. As indicated by Mr. Rustomjee, Malawi would need to generate a minimum of a 5.3 percent real growth rate to prevent the number of the poor from increasing. Moreover, the country faces other challenges, including an unsustainable debt burden and unfavorable developments in the terms of trade. These constraints have been exacerbated by the high prevalence of HIV/AIDS, which has reduced markedly the most productive human capital.

The authorities are determined to keep the momentum of macroeconomic stabilization and to deepen structural reforms, building on the progress achieved under the ESAF arrangement. These efforts merit the strong support of the international community. The proposed program includes key policy measures, which could help achieve the objectives of higher growth and poverty reduction contemplated in their Interim PRSP. In particular, the projected reduction in the overall fiscal balance, mainly through a strengthened expenditure management, should reduce government borrowing and help avoid the accumulation of domestic arrears, which have tended to crowd out private sector activities. We also welcome the emphasis put on governance and transparency in budget operations, which will ensure the efficient use of budget allocations, particularly, in favor of the social sectors. The process of administrative decentralization should help in the effective delivery of basic services. We welcome the authorities' commitment to a prudent monetary policy, which will contribute to low inflation, essential not only for investor's confidence, but also for external competitiveness. However, in order to promote financial intermediation and to ensure a smooth monetary policy, the authorities are encouraged to maintain the current soundness of the banking system, through strengthened banking supervision.

The Malawian authorities have produced an Interim PRSP in which they set the priorities in their fight against poverty. Macro-economic stability and the establishment of an environment conducive to private investment occupy a prominent role in their poverty reduction strategy. The government has also put emphasis on consultation with a wide range of stakeholders, including the private sector, NGOs, donors, civil society, religious organizations, as well as representatives of the poor. The strengthening of the participatory process since the advent of democracy in 1994 should facilitate the rapid completion of a full, participatory PRSP. However, given the existing capacity constraints, the need for increased technical assistance cannot be over-emphasized. In particular, assistance from the international community is needed to better articulate public expenditure reviews and the medium-term expenditure framework as well as the design of social safety net programs.

We commend the authorities' commitment to combating corruption and fraud and for establishing the Anti-Corruption Bureau, the Department of Public Prosecutions, and the Auditor-General. Thanks to these bodies, good governance has been gaining ground. However, we concur with staff that the PRSP should focus more on judicial reforms and on additional mechanisms to strengthen accountability and transparency in government finance.

The last Board meeting on Malawi concluded that Malawi qualifies for assistance under the HIPC Initiative, since the DSA indicated that Malawi's debt would remain unsustainable even after the use of the traditional debt-relief mechanisms. Given the overall good track record of policy implementation under the ESAF arrangement, and the authorities' commitment to reforms, as reflected in their medium-term program, we consider that the country has met the conditions for reaching the decision point this year and for benefiting from interim assistance under the enhanced HIPC.

We also agree that the triggers for the floating completion point cover the areas that will ensure that HIPC resources will be effectively used for poverty reduction. With adequate technical and financial assistance, we think that they are within the authorities' reach.

Mr. Pickford made the following statement:

I thank the staff for a set of useful documents. I found that the Article IV consultation and PRGF paper identified the main issue of concern accelerating the country's economic growth rate. Increasing private-sector participation, stimulating nontraditional exports, and regional initiatives are key factors to raising the nation's growth and earnings.

I am happy to approve the request for a new arrangement supported by the PRGF, as it has a firm grounding in prior actions and broader-based ownership than previous programs. The staff deserves a great deal of credit for bringing about that change. The government's commitment to strong macroeconomic and structural policies is starting to be demonstrated, especially in terms of a number of difficult decisions, for example on liberalization measures in the areas of agriculture, telecoms, and petroleum. While ambitious, the program is also feasible. As such, I am particularly heartened by the fact that the parliament supports the overall policy approach, as well as the specific measures to tighten expenditure control. The absence of an overarching strategy for public-sector reform may limit the impact of other reforms, and I would encourage the government to consider this in moving toward a fully-developed PRSP. There is also an urgent need to deal with the arrears problem, as well as with the parastatals.

The staff report was particularly helpful in describing the concern over governance. I would, therefore, support the inclusion of structural benchmarks, as they would be key to establishing accountability. Given the present weaknesses and limited staffing of the judicial system in Malawi, it is likely to take some time, even longer than we would have hoped, to achieve results. Nevertheless, every effort should be made to make progress in this area.

I agree with the staff assessment of the country's progress in improving policy implementation, and, therefore, agree that Malawi should reach a decision point today. Although there have been temporary lapses in control, the authorities have demonstrated a sufficient track record of instituting macroeconomic reform and poverty reduction measures to warrant proceeding ahead. In addition, the authorities have exhibited significant efforts in improving public finance management and, in particular, addressing the issue of domestic arrears. As I have already mentioned, however, this is still an area where sustained efforts and results would be required.

I also agree with the provision of interim relief, and it is useful to have been provided with details on the intended use of those funds. If Malawi is to make the best use of those resources, it is essential to avoid future policy lapses.

On debt sustainability, Malawi is not expected to be able to reduce its debt burden to a manageable level until the middle of the next decade or 2014. Even that estimate is optimistic, in light of Malawi's vulnerability to shocks given its dependence on tobacco exports.

This is a problem for a number of HIPC countries, and possible mechanisms to address it should be considered in the upcoming paper on debt sustainability. Our general position in that regard is that we would be prepared to reassess the countries' economic stability at the completion point. However, we would encourage the authorities in Malawi to develop a strategy for effective debt management, including policies on future borrowing.

On the completion point triggers, I do think that they focus on the key areas of reform and build on existing initiatives. Progress on public sector and labor market reforms will be needed in order to continue to advance with reforms in the health and education areas. I would urge the government to address these issues while developing and implementing the PRSP.

The governance trigger is also significant. More detail on this trigger would have been preferable, but the combination of the structural benchmarks on improving governance reflected in the PRGF and the trigger point itself should prove to be adequate.

The Interim PRSP provides a satisfactory foundation for a full PRSP. There have already been delays in the timetable set for producing the document, so we would urge the government to ensure that sufficient resources and time are made available to develop a comprehensive strategy that would command broad-based support.

The following five issues would require further development in moving toward the full PRSP:

First, there needs to be greater focus on the analysis of poverty, both with regard to its causes and the policies to reduce its incidence;

Second, participatory monitoring processes will be key to effective implementation, and, therefore, the full PRSP should provide details on such monitoring arrangements;

Third, the established policy matrix is an ambitious one, so prioritization will be crucial. We would hope that those priorities would be discussed in the elaboration of the monitoring process as well as throughout the MTEF, as we view them as key to recognizing the budget constraints;

Fourth, the MTEF and the budgetary processes will need to be fully integrated into the PRSP. The PRSP process has compelled the authorities to focus on priorities for the use of limited resources and it has encouraged the adoption of an outcomes-based approach. Reinforcing these steps with enhancements in public finance management is encouraging. Interim assistance will help to maintain the momentum of the progress seen thus far, and we are encouraged by indications that the interim assistance will be constructively utilized.

Finally, the high level of HIV/AIDS infection rates will have a devastating impact on Malawi, both in human and economic terms. Needless to say, that is a high priority issue, which the government must address as part of the PRSP.

Mr. Haupt made the following statement:

Malawi's debt and poverty indicators make it a clear candidate for the enhanced HIPC-Initiative. We also acknowledge the overall -- though not uninterrupted -- progress achieved under the last ESAF-arrangement. As to the Interim-PRSP prepared by the authorities, it is, in our view, a reasonable basis on which to move forward. Against this background, we can go along with the proposed decisions. Since I agree with the thrust of the documents prepared by Staff, I shall only make three further comments:

Staff's longer-term debt and balance-of-payments projections -- even after HIPC assistance -- are rather sobering. Also, like Mr. Pickford, I have the impression that Staff's baseline scenario depends on fairly ambitious growth and terms-of-trade-assumptions. The significant downward revision of growth projections for 2001 and 2002 by more than two percentage points since this last July is only one of many indications of the high vulnerability of the Malawian economy. This constellation points to the possibility that Malawi's debt situation may indeed have to be reassessed at the time of the completion point. Above all, however, it underlines the urgent need for strong policies and reforms that are vital in the long term for saving the country from the debt trap.

As to the new program, the risks -- in particular in the fiscal area -- cannot be overlooked, although the program seems within the reach of achieving. It is imperative that monetary policy not be slackened again and that the new expenditure monitoring system be firmly implemented. With regard to structural reform, the market-oriented measures agreed under the program and recommended by Staff, including privatization, liberalization and enhancing competition in the banking sector, are essential to improve Malawi's growth potential and promote diversification. Also, resolute efforts in the area of good governance are indispensable to improve business climate and stabilize the economy. The measures agreed under the program seem encouraging in this regard.

Finally, on Malawi's Poverty Reduction Strategy and the floating completion point: The key challenge in preparing the full PRSP will be to transform the comprehensive list of goals into a strategy of prioritized, costed and monitorable measures that are consistent with existing budgetary and administrative constraints. As to the proposed list of triggers, on the whole, they certainly appear to be appropriately ambitious, given the limited administrative capacities. However, in view of the urgency of the governance problem in Malawi, we favor a somewhat better coverage of this complex in the triggers. For instance, the actions listed in paragraph 18 of the Decision Point Document could be reflected in the triggers to a larger degree than is the case now. Also, we would welcome a stronger emphasis to be put in the Interim PRSP and/or in the triggers on the aspect of decentralization, including the role to be played by the District Assemblies.

Ms. Kornitch stated that she supported the proposed decision.

Mr. Ioannou made the following statement:

I broadly share the staff's assessment and will focus my remarks on a few areas.

The growth rate targets envisaged under the program do not seem ambitious enough to lead to a noticeable reduction in poverty, even over the medium term. Furthermore, the program does not place sufficient emphasis on strategies to promote macroeconomic stability and reduce vulnerabilities, particularly, of the rural poor who rely on agriculture.

The staff report appropriately stresses the need to reduce inflation over the short term. However, I have reservations about the feasibility of the planned reduction of inflation by 20 percentage points in 2001, especially when the exchange rate is already considerably depreciated.

In the area of public finances, fiscal consolidation in support of monetary tightening will contribute toward the reduction of inflation and the current account deficit. It will also contribute to the development of the private sector by facilitating a reduction in real interest rates. The attainment of an overall budget balance in fiscal year 2000-2001 is a welcome development. Nevertheless, I note that this improvement was largely the result of increased foreign aid and the depreciation of the domestic currency rather than due to domestic policies. To attain fiscal discipline and clear arrears, the authorities need to strengthen the control and monitoring of expenditures. Strict control over spending and serious efforts to improve governance to address the incidence of fraud are essential.

Turning to the HIPC Initiative, the authorities clearly face an unsustainable debt burden. Their track record of policy implementation, however, has not been consistent over the years. Policy performance under the 1995-1999 ESAF has been mixed. In 2000, there has been no PRGF arrangement due to the government's delays in addressing the issues of domestic arrears. Even in the absence of such conditionality, economic performance in 2000 was marked by slippages, especially in the monetary area.

The Interim PRSP is a step in the right direction and I welcome the recent household income expenditure survey. A good deal remains to be done, however, as highlighted by the staff. I would only like to add the importance of taking measures to improve the highly skewed distribution of income and ensure the proper use of resources following the provision of HIPC assistance.

Given the substantial amount of work that is pending, I urge the authorities not to rush the preparation of the final PRSP. The provision of interim assistance at the decision point is, in fact, intended to ensure that countries do not sacrifice quality by preparing a PRSP too rapidly. A quality PRSP is necessary to ensure that gains in poverty alleviation can be sustained over the longer term, in contrast with the many poverty initiatives of the past. In that regard, the time schedule envisioned by the authorities for completing the PRSP a few months after the decision point is overly ambitious.

Given the flexibility, which this chair is willing to demonstrate in agreeing that Malawi can reach the decision point now, I trust that the authorities will be more vigorous in meeting the conditions for the completion point, which I generally support. I welcome the details provided on the health and education triggers, but I consider the safety net triggers to be rather broad and vague.

Finally, as with some other recent HIPC cases, it is disappointing that debt relief under the HIPC Initiative will not achieve debt sustainability. The sensitivity analysis indicates that the situation might end up being considerably worse than what was envisaged under the baseline scenario. While the staff notes that additional debt relief may be required at the completion point, it is not clear whether the current HIPC rules apply to countries facing long-term structural weaknesses in particular sectors or industries. The spirit of the existing rules, as I understand them, is that additional debt relief at the completion point could be provided if one country has a sustainable debt position at the decision point – which is not the case here – and unforeseen shocks during the period between the decision and the completion points render the debt position unsustainable at the completion point.

Mr. Skurzewski made the following statement:

Let me start from the issue of the decision point. Our position today is in line with the one that we indicated during the discussion of Malawi's preliminary HIPC document in August. In our judgment the country does not satisfy the criteria of reaching this point today. Performance under the programs implemented over the last three years has been mixed, there were significant policy slippages, and adding to this, there is nearly a one-year gap since the end of the last PRGF. As we said earlier, we would prefer to approve the decision point after successful review of the new arrangement. For these reasons, we would like to be recorded as abstaining from accepting the decision point under the HIPC Initiative.

Further to the proposed PRGF arrangement, we are concerned that it is to be implemented retroactively: the second disbursement is set for mid-February, based on performance criteria as of only ten days from now. As we understand this, the beginning of the arrangement is thus dated back to August 15, 2000, i.e. by more than four months back. We have doubts about the adequacy of proceeding in this way. Are we still in line with the Guidelines on Performance Criteria and Phasing, which set three months as a limit for the time between approval of a program by the Management and its discussion in the Board? In any case, I think we miss an explanation on the proposed phasing and retroactivity in the document. We do not appreciate this in-transparency.

Turning now to the more positive part of my statement, we have no doubts about Malawi's eligibility for assistance under the HIPC Initiative. Traditional debt relief would be far from sufficient to remove the country's debt overhang, since much of the liabilities to the Paris Club creditors are not eligible for restructuring under the Naples terms. We thus welcome the fact that Malawi will be able to profit from HIPC assistance and increase the resources available for promoting growth and reducing poverty. The Interim PRSP, together with the PRGF-supported strategy, focus on the macroeconomic stability, strengthening public expenditures, promoting private sector development and implementing a comprehensive and efficient social safety net, which we recognize as the exactly right priorities. Staff have reached a sound judgment on the quality of Malawi's Interim PRSP and identified some important points that should be addressed in formulating the full-fledged strategy. The proposed completion point triggers should provide adequate assurance that the resources saved through HIPC assistance would be efficiently utilized. We, particularly, welcome the envisaged measures against the further spreading of HIV/AIDS, the prevalence of which is one of the highest in the world, and not only has tragic consequences for the citizens, but also significantly hampers economic growth. In this context we are glad to note that a part of the recent donors' pledges will be used toward this goal.

Among the structural targets, we see much merit in the governance-oriented measures in the area of fiscal and expenditure management, since deficiencies in this domain were chiefly responsible for Malawi going off track in the past. We welcome the establishment of the Anti-Corruption Bureau and enhancement of other institutions active in this field, and we look forward to see more concrete results of their work, which is also subject to one of the structural benchmarks. We would also emphasize the importance of improving the public procurement law and related procedures, since it seems to us that some of the problems in the past were related to these issues. We hope that the staff will be able to look at these revisions once they are passed by the Parliament and provide the Board with their assessment at the time of the next review.

With these remarks we support other proposed decisions, *i.e.,* the conclusion of the PRGF arrangement and endorsement of the Interim PRSP.

Mr. Fenton made the following statement:

I thank the staff for the concise set of documents prepared for today, as well as Mr. Rustomjee for his statement.

We consider that the Interim PRSP provides a sound basis for the development of a full PRSP, the initial use of debt relief, and for the PRGF arrangement. We welcome the balanced nature of the Interim PRSP, which clearly recognizes the importance of macroeconomic stability and growth for

poverty reduction. In that context, the emphasis placed on the link between raising cash crop exports and agricultural production by small land owners and reduction of rural poverty is important, as is the outline of the essential steps to create a regulatory framework conducive to private-sector expansion.

We welcome the candor of the Interim PRSP in acknowledging the authorities' past record of not carrying out plans. In light of that history, the full PRSP should contain both overall strategies and specific plans for implementation, which are commensurate with Malawi's capacity. Similarly, it would be beneficial to define a limited set of targets on which the PRSP would be assessed along with the appropriate indicators for monitoring purposes.

There are several areas that merit closer attention in the full PRSP. One such area is governance. Measures are required to strengthen the monitoring and control of public spending. The lessons learned from the public expenditure review, for example, should be incorporated into the PRSP.

It would also be useful to include an analysis of possible market opportunities for Malawi's exports, resulting from regional integration and preferential trade initiatives by some developed countries.

While it is encouraging to see that some HIPC resources have been earmarked to youth services, we note that issues of gender are virtually absent from the Interim PRSP analysis. A good deal of work must be done to integrate the gender-poverty nexus within the PRSP analysis and in the subsequent decision-making process. Finally, like Mr. Pickford, we think it is important to address the grave problem posed by the HIV/AIDS virus.

Turning to the PRGF arrangement, we think that the economic program to be supported by the new PRGF arrangement is consistent with the Interim PRSP's priorities and has the determined support of the authorities. Accordingly, we can support that arrangement.

Looking ahead, we would expect that as the PRSP evolves, the PRGF arrangement will be adjusted accordingly.

Turning to the HIPC Initiative document, we think that Malawi has demonstrated sufficient commitment to poverty reduction to warrant reaching the decision point under the enhanced HIPC Initiative now. We also agree with providing interim relief. However, we are concerned that the export and GDP growth projections are overly optimistic, as they do not take into account the high probability of exogenous shocks, particularly, from rainfall and the shrinking tobacco market. As such, we are prepared to reassess the amount of assistance at the completion point.

The triggers for the floating completion point in Box 2 represent a limited, concrete, and critical set of policy actions that are broadly consistent with Malawi's Interim PRSP. We agree with them and place particular importance on the triggers related to governance.

Mr. Santos made the following statement:

We believe that the challenges ahead will call for a very strong policy performance, and the stop-and-go approach to policy implementation of the recent years will not deliver the needed results. Malawi is another case where the strategy for poverty alleviation should focus on the adoption of growth-friendly policies that are also consistent with a more equitable pattern of growth. In our view, stabilization policies that allow a decline in inflation and a steadfast implementation of structural reforms fit the bill perfectly. The feasibility of this policy prescription is clearly illustrated by the experience of the mid-1990s, when a regime of high growth and low inflation prevailed.

I would now make a few specific comments. First, on the inflation outlook, we have some trouble reconciling a sharp depreciation of the currency in real effective terms that occurred in the second half of this year with a sizeable reduction in inflation in 2001, even because the pass through into domestic prices may not be completed. Moreover, the information provided in the supplement, pointing to a likely breach of the end-December reserve money target, raises additional doubts about the achievability of the inflation target.

Second point, on the financing of the program, we note that there remains a financing gap during the program period, which is assumed to be closed by additional grants. We would appreciate if staff could provide information on the likely source of these grants.

Finally, we are concerned that one key prior action is not being fully implemented, namely the prior action according to which line ministries should maintain commitment registers and submit monthly reports on commitments and arrears to the Ministry of Finance. In the supplement issued yesterday staff notes that so far the coverage of the information provided is incomplete and quality is mixed. As we all remember from the last discussion, a waiver had to be granted for the noncomplying disbursement implied by unreported arrears. Hence, we attach great importance to a strengthening of the monitoring and control of public expenditures, which is a main element of the PRGF conditionality.

On the HIPC, there are two points. First, on the quality and length of the track record, in the case of Malawi, the track record of Fund-supported programs has been interrupted now for 1 year. Hence, although all prior actions have been met, this is not an adequate substitute for good performance

under Fund-supported programs. While we are willing to go along with the proposed decision, we would have preferred that the DP had been reached only after a track record of policy implementation had been reestablished, even for a short period of time.

Finally, on the sustainability of the debt, in many other HIPCs, the NPV of debt-to-exports ratio stays above the 150 percent threshold throughout the decade, despite heroic assumptions for official grants and the growth of non-traditional exports over the projection period. This raises questions on the medium term viability of the Malawian economy and its capacity to graduate from Fund support and concessional lending in general. More importantly, however, it raises questions about the credibility of the Initiative. The staff points out that the Fund and Bank Boards can consider at the CP a topping up of the committed debt relief. That is indeed the case, but we note that would depend on the observance of unfavorable exogenous events. A long term projection of the NPV ratio above 150 percent, per se, does not ensure a reconsideration of the amount of debt relief committed.

Mr. Abbott made the following statement:

The Interim-PRSP is overly general and does not clearly delineate priorities. Nevertheless, it is adequate as a preliminary roadmap. We support the analysis and recommendations provided in the Joint Staff Assessment of the Interim PRSP. In the final PRSP, we hope the authorities will present a growth strategy based on private sector development and export diversification. The program should be designed in such a way that a limited number of quantifiable and monitorable targets can be established.

Achieving macro-stability must be the linchpin in the growth and poverty reduction strategy. To achieve the growth levels that have been targeted, greater investment will be needed in productive sectors and further liberalization of economic activity will be required. Shifting budgetary allocations toward health and education is already being done but there now needs to be an intensified focus on improving the quality of services delivered. Public accountability and expenditure control need to be strengthened. We support the suggestion of forming a National Steering Committee at the executive level, but we would also like to see more vigorous parliamentary oversight. Civil society is well organized, and their participation needs to be fully exploited in developing and overseeing the poverty reduction strategy.

We support the macroeconomic objectives and policies in support of the three-year PRGF and the specific measures to be undertaken in the first year of this arrangement. An economic environment of low inflation, a contained current account deficit and a cushion of reserves will be essential to achieve the macro stability that will serve as a starting point for the growth

and poverty reduction targets of this program. Lower inflation is not just a key feature of macro stability. It will directly improve the well being of the poorest. In the reviews of this program, we will be insisting on adherence to budgetary disciplines that are summarized in Table 2. The other requirements and objectives of the program are no less important, but they cannot be met unless fiscal discipline is maintained.

Stronger administration and improved governance will be required up and down the line if the core requirement of fiscal discipline is to be delivered. This has not been Malawi's strong suit heretofore. We will be looking for firmer program management and greater vigilance in the fight against corruption. We hope to see more resolute actions like the government's November decision to suspend funding for eleven ministries and departments for non-compliance with their requirements of the expenditure and commitment reporting system. Full elimination of arrears will be a signal of stronger fiscal discipline. We hope to see fewer presidential trips, a smaller cabinet, containment of civil service salaries, including those of the parliament, reduced per diem rates, fewer stories about purchases of S-class Mercedes Benz, less auto financing for parliamentarians. In general, we hope to see far fewer of the stories like those reported in Box 4.

We are pleased to see that the completion point triggers, especially those relating to quarterly expenditure reports, health, education, and HIV/AIDS have quantifiable and monitorable targets. Within a more disciplined expenditure framework, we will need to be able to demonstrate that the priorities of the PRGF really are being tended to. We are also pleased that the uses of interim relief were outlined in the Decision Point document but would have liked to have seen a trigger on verifying the use of interim relief stipulated as a completion point trigger. We agree with Mr. Santos regarding the timing of the Decision Point.

We are skeptical about the prospects for achieving debt sustainability. The early trajectory looks feasible, but after 2003 the estimates look very optimistic.

Mr. Al Azzaz made the following statement:

It is encouraging to note that the Malawian' authorities are firmly committed to reestablishing macroeconomic stability and deepening structural reforms. The key to success, however, is steadfast and sustained implementation of the agreed policies. Given the strength of the proposed program, the recent encouraging signs in economic policies and performance, and Mr. Rustomjee's statement on the authorities' commitment to reform, I support Malawi's request for arrangement under PRGF.

Since I broadly agree with staff appraisal, I will make few brief remarks.

A tight fiscal policy stance is rightly the cornerstone of the authorities' program. Improved prioritization and efficiency of government spending should reduce government borrowing and help avoid the accumulation of domestic arrears. In this regard, full achievement of the targeted reduction in the fiscal deficit is a priority. Such policies are needed to tighten the fiscal stance while providing for increased social spending and the investments required to enhance growth prospects.

The inflation and external sector objectives will also require a prudent monetary policy. Here, deepening the financial sector and increasing competition are essential. In this regard, I welcome the authorities focus on privatizing commercial banks and their intention to further strengthen banking supervision and prudential standards.

To achieve the full potential of the macroeconomic adjustment efforts, the authorities need to continue to press ahead with structural reform in other areas. The market-oriented measures along with reform in the agriculture sector are especially important. Notwithstanding the progress being made in the privatization program, I urge the authorities to accelerate the pace and extend the involvement of the private sector.

With regard to the Interim PRSP and joint staff assessment, I broadly concur with the joint staff appraisal. I also agree that this Interim PRSP provides a sound basis for the development of a fully participatory PRSP.

Turning to the HIPC decision point document, I agree to the proposed decision point and provision of interim assistance. I also agree that the triggers are broadly appropriate for the completion point.

Ms. Boucher made the following statement:

I thank the staff for the well-written set of papers before us today and Mr. Rustomjee for his candid and comprehensive statement, which correctly highlights the strength and vulnerabilities, as well as the major challenges ahead, for the authorities in Malawi. The efforts initiated by the government since the first democratic elections in 1994 to stabilize the macroeconomic environment, implement structural reforms, and foster growth are commendable. However, the achievements remain mixed. Although still modest, growth rates have accelerated in comparison to pre-1994. Revenue collection has improved; and the exchange rate and foreign exchange reserves have stabilized, despite the policy lapses that resulted from the election process in May 1999. Indeed, as underlined by Mr. Rustomjee, the major challenge is to restore and sustain macroeconomic stability in order to return

the economy to a path of higher growth, which would affect the basis for a substantial and lasting reduction in poverty. In that respect, I share the views expressed by some Directors that the growth rate targets might not be ambitious enough. To reach the objective of sustained macroeconomic stability and growth, we believe that the authorities should concentrate on the following:

First, on the fiscal stance, it is crucial that the authorities continue their efforts to strengthen expenditure control and oversight by expanding the medium-term expenditure framework to all ministries, especially in view of the assistance that will be provided under the HIPC Initiative.

Second, growth oriented measures are essential. Malawi remains to a large extent dependent on tobacco exports. Further trade liberalization and measures aimed at strengthening and diversifying the private sector will enable the country to fully benefit from its comparative advantages, such as lower labor costs, relatively stable legal environment, and social consensus.

Private sector's access to financing will also need to be improved. In this regard, we fully support the staff's recommendation concerning the excessive level of voluntary reserve requirements, which resulted in a very high spread between deposit and lending rates.

Third, we feel that additional efforts are required on the part of the authorities for the privatization program to regain momentum.

Turning to the Interim PRSP, we feel that the document could have substantiated the choice of quantitative objectives or impact indicators. There is no clear connection between these and the macroeconomic plan, and we would also have liked better fiscal prioritization of the sectoral programs. We join other Directors in stressing the considerable challenge posed by the high prevalence of HIV/AIDS, an issue that should remain high on the authorities' agenda.

We encourage the authorities to devote sufficient time to producing a comprehensive PRSP.

To conclude, I can support the proposed decision on the PRGF review and the decision point, and wish the authorities every success in their future endeavors.

Mr. Rouai made the following statement:

I thank the staff for the well-written reports, and Mr. Rustomjee for his very informative statement. Malawi is one of the poorest countries in the world with very weak social indicators. The PRGF arrangement rightly

emphasizes improving and sustaining economic growth and pay special attention to the budget. Improving revenues and streamlining expenditures need to be continued to prevent the re-emergence of arrears and to provide additional resources to the social sectors in view of the widespread AIDS. The DSA clearly show that the debt burden will remain unsustainable even after traditional debt relief. This is typical of HIPC countries. What worries me in the case of Malawi is that even after HIPC relief prospects remain very difficult for two reasons:

First, macroeconomic assumptions under the PRGF arrangement and the HIPC calculations are based on a rate of growth averaging 4.3 percent between 2000-2001, which is low for poverty reduction. According to Mr. Rustomjee's reference to the World Bank studies, Malawi needs to generate a minimum of 5.3 percent of real annual growth in order to prevent the number of the poor from increasing.

Second, the level of NPV of debt-to-export after the completion point is projected to exceed the ratio of 150. Like in the case of Rwanda, I urge the staff to keep this issue under review.

Finally, I endorse the Interim PRSP and support the decisions on the PRGF and HIPC Initiative. I wish the authorities success in their endeavors.

Mr. Sigurgeirsson made the following statement:

I support today's decisions, with some hesitation, as I still have some concerns regarding the lack of a recent and current track record, especially when taking into account the mixed policy implementation in the past. It is necessary for the authorities to realize that macroeconomic stability is key to fighting poverty.

In addition to a lack of a track record, I have concerns about very recent problems with governance. The long and sad list put forward in Box 4, in the Article IV review, underlines the urgent need for balanced measures to confront corruption. In this respect, I welcome the measures put forward in Mr. Rustomjee's Preliminary Report and the inclusion of specific measures to pursue all evidence of fraud, as a structural benchmark.

On a related issue, I very much support plans to improve the Expenditure Framework, but I would have seen the completion of an operational Medium-Term Expenditure Framework built into the program. A proper framework would give some assurances on the allocation of funds that are to be released by debt relief.

Finally, with the ambitious nature of this program, it is my hope that the assumptions used in the program prove realistic, especially with Malawi's past history of vulnerability to exogenous shocks.

Ms. Phang made the following statement:

This chair would like to thank staff for their candid assessment of the current economic situation and the problems faced by the Malawi economy. We would also like to commend staff on their insightful analysis of the critical factors for success in poverty reduction in Malawi.

Turning to the first issue of whether Malawi qualifies for assistance under the enhanced HIPC Initiative, we support the staff's recommendation for providing assistance even though Malawi does not satisfy the fiscal criteria which requires thresholds of 15 percent and 30 percent of GDP for the fiscal and export ratios respectively, as candidly admitted in footnote 30 of the Decision Point document. This is because Malawi continues to remain one of the poorest countries in the world due largely to factors outside its control. We note that aside from Mozambique and Botswana, Malawi has been receiving more ODA per capita than any other country in Sub Saharan Africa. However, despite sizable inflows of foreign aid, its growth performance has been weak. Since this was largely because much of the aid was channeled into consumption rather than investment (based on the study, only less than 23 percent of the aid went into projects), we would like to highlight the following concerns in relation to the poverty reduction strategy:

Firstly, we affirm our strong support for the three-prong strategy outlined in the Interim PRSP. However, we would like to emphasize that as stated on pg. 13 of that paper, all three prongs are necessary and significant poverty reduction will not be possible if only one of the prongs or approaches is implemented. Since funds are limited, prioritization is essential. While we agree that governance and the social issues are indeed important and are very well covered in the document, nevertheless, it would appear from Box 2 that relatively less weight has been attached to projects or activities which would have a stronger or more immediate impact on generating growth, which we would like to emphasize is a necessary condition for alleviating poverty. Since savings and investment by the private sector in Malawi is even lower than the rest of the Sub Saharan Africa, there is a need to encourage foreign direct investment. However, Box 1 of the Decision Point document shows that not only is FDI low, but it is largely in mineral exploration where the spillover benefits are relatively small compared to, say, manufacturing.

Secondly, while the strategy paper had given recognition to the importance of diversifying the export base of the Malawi economy, we note that most strategies had been confined to the agricultural sector. We recognize that there may be many obstacles to diversify the export base and to

encourage private sector participation. One of the obstacles is the lack of good infrastructure because high transportation cost can be a significant impediment for a land-locked country like Malawi. Measures to improve the physical infrastructure, in turn, require heavy capital outlays. We would appreciate staff's comment on this.

Thirdly, availability of credit is one of the critical factors to facilitate economic activity. Hence, we commend the authorities' commitment to further strengthen banking supervision and prudential standards. Although the average risk-weighted capital asset ratio was about 24 percent and non-performing loans had declined to 2.5 percent of assets, nevertheless, financial stability could still remain elusive as inflation is high and the two largest commercial banks account for 90 percent of deposits but lend only to a restricted number of companies. We therefore urge the authorities to put on high priority the resolution of the problem of connected and insider lending.

With these remarks, we support the authorities' request for assistance in their poverty reduction program and we wish them every success in their endeavor.

Mrs. Manalac made the following statement:

We wish to express our support for decisions on both the PRGF and the HIPC Initiatives. This is not to say, however, that we do not have our concerns, particularly in view of the uneven performance record of the authorities. But the situation that Malawi faces is not distinctly different from that of other HIPC Initiative countries for which this chair provided support in the past. We extend our support on the basis of the staff's assessment and advice, as well as on the authorities' commitment that continued efforts would be exerted to achieve the goals.

Mr. Harada stated that he supported Malawi reaching the decision point and the new arrangement under the PRGF.

Mr. Maino made the following statement:

Malawi has shown progress in the fiscal area. We welcome the tight fiscal stance for 2001, which includes enhanced revenue collection and decline in government expenditure as a share of GDP. I associate myself with the candid analysis made by Mr. Ondo Mañe in his statement on the prospects of fiscal policy and the efforts made to strengthen expenditure management.

Let me advance a point we made yesterday for the case of Guinea. It is recommended that there is a clear demarcation between the central bank and central government. In order to restore credibility, transfers from the central bank to finance the central government should be halted. High inflation rates

are today the consequence of an accommodated monetary policy dominated by fiscal pressures.

We are not fully confident that the current strategy will be enough to foster economic growth. The Article IV Consultation Report expresses that the main challenge for Malawi is to move to a higher growth path. Also, in his quite informative preliminary report statement, Mr. Rustomjee underlines the same challenge. In this regard, we welcome the four main pillars for growth advanced by the government. But, once again, we believe it is not enough.

It is obvious that the banking sector – dominated by two banks in which the government has a considerable stake- is not prepared to lead the growth process by providing the necessary financing for small-scale enterprises. However, we welcome the intentions to further strengthening banking supervision and prudential standards.

Also, the saving and investment levels are still too low – as staff mentioned- in order to help in the reconstruction immediately. Nevertheless, the government can help by pursuing a policy to attain fiscal surpluses and by reinforcing property rights to back up private savings.

The internal ingredients for growth are still not ready to help the engine of growth.

But let me mention once again the need to focus on trade. Trade is good for growth. And growth is good for the poor. We encourage Malawi to try to exploit the opportunities provided by bilateral and multilateral agreements for market access as depicted in Chapter III of the Statistical Appendix. Also it is vital to adopt a fully flexible, market-determined exchange rate. By next March´s review we would like to hear more on the progress made in this area.

The other pillar is the need to restore external means of financing, namely the equity market. Malawi should make private sector development part of its central goal in order to at least try to promote capital inflows. Legal uncertainty on property rights should be tackled immediately.

That being said let me underline that we believe Malawi qualifies for assistance under the HIPC Initiative so the country can reach its Decision Point today. Also, we agree to provide interim assistance between the decision and completion point. The output-oriented triggers depicted in Box 2 of the HIPC document are appropriate given the social situation in Malawi.

Mr. Bakhache made the following statement:

While showing overall improvement, macroeconomic performance in Malawi in the second half of the 1990's has been more or less erratic as evidenced by the behavior of inflation, money growth, and fiscal deficit to mention a few variables. Exogenous factors have no doubt been partly responsible for this performance. Policy actions on the macro and structural fronts have also been unfavorable for establishing a sound macro environment. These factors have adversely impacted growth performance and impaired the efforts to reduce poverty.

We fully agree with the staff that establishing macroeconomic stability is a necessary condition for achieving higher growth rates and increasing income of the poor. In this regard, while we think the target may be too ambitious, and recent indications show that inflation remained at 35 percent in November, we are pleased that the authorities are firmly committed to reducing inflation through a tighter monetary stance.

Fiscal discipline should be at the heart of the efforts to achieve program objectives. The ten-point plan announced early in the year seems to provide a good and clear road map for improving the overall fiscal performance. We share other Directors' views regarding the importance of the determined application of the new system for monitoring and controlling spending of line ministries.

Important progress has been made in structural areas particularly the liberalization of the agriculture sector. We concur with the staff that measures that would restrict opportunities for smallholders in the tobacco sector should be avoided. Regarding privatization, we are pleased that there is a recognition that a lot of work needs to be done to improve the attractiveness of public assets for investors.

On the HIPC Initiative, as we stated during the last board discussion on Malawi, we would be prepared to support a decision point before the end of the year, provided a new program is in place and the Interim PRSP is prepared. We can go along with the staff's and management recommendations regarding the completion point triggers. On the I-PRSP, like others we see a need for further work to prioritize and cost the large number of policy measures contemplated.

Finally, I would like to make a point unrelated to the program or the HIPC. The paper on the selected issues was issued as background material for today's discussion on December 15th that is in the middle of the busiest HIPC week. The paper does not seem quite timely. We were under the impression that we need to streamline our work and procedures on HIPC's because we are short on time and resources. We understand that there may be an internal

procedure relating to background papers that needs to be followed. However, we frankly did not have time to look at the paper and we understand that staff resources are already stretched. This is not meant to undermine the hard work that went into the preparation of all the useful documents in front of us. To the contrary, we thought the papers were concise and nicely written. However, the volume of the other documents is overwhelming enough.

Mr. Josz made the following statement:

I share the concerns of many Directors about Malawi's poor track record of macroeconomic stabilization and governance. However, I agree with the proposed decision to bring Malawi to its HIPC decision point in view of the priority given to speeding up the implementation of the Initiative.

I commend the staff for their candor about the seriousness of Malawi's governance problems. It will be crucial to put effective monitoring mechanisms in place to ensure that the resources made available up by HIPC debt relief are productively used to foster growth and poverty reduction.

Like other Directors, I do not believe that the possibility, under the HIPC Initiative, of "topping up" debt relief at the completion point in case of adverse shocks, was meant for cases like Malawi's, whose limited ability to afford external debt is primarily caused by long-standing structural weaknesses.

Mr. Suarez made the following statement:

We support the proposed decision on Malawi's reaching the decision point. We recognize that macroeconomic stability will be achieved only if prudent fiscal and monetary policies are upheld. We are concerned with the levels of interest prevalent in Malawi's economy, which are a disincentive for investment. The increased cost of borrowing will constrain private investment, thereby reducing economic activity. Although there is a need for tight monetary policy, we must also think about stimulating economic growth. In that respect, the projections provided are perhaps too optimistic.

The staff representative from the African Department stated that, in the light of the major problems of fiscal control in Malawi in the past, there had been substantial efforts to improve the ways in which public expenditure priorities were determined, commitments were made and services delivered. One of the underlying components of the prioritization effort was the elaboration of a medium-term expenditure framework, which had been developed over a number of years. Among the other elements were public expenditure reviews which, in 1999/2000, had been instrumental in establishing priorities within various sectors, particularly in health and education for the following fiscal year. Part of the consultative process of the PRSP would also reconcile the priorities of various parties and the government. The ambitious timetable for the PRSP ,which envisaged completion by

June 2001, was designed to inform priorities for the 2001/2002 fiscal year; the authorities were eager to adhere to that schedule.

The completion point triggers included some specific measures to enhance governance, such as improvements in the auditing process, the staff representative commented. Some of the other triggers included procedures to improve the allocation of funds and avoid leakage, including the delivery of medical supplies and text books. The goal was to ensure that goods reached the people for whom they were intended.

On promoting the private sector, various measures had been taken to improve the poor state of the country's infrastructure, which had been an impediment to private-sector development and growth, the staff representative noted. For example, a separate account for road maintenance had been established to make certain that the revenue collected from levies on oil would be used for this purpose. One of the areas that had been identified by the government for use of HIPC resources was rural road expenditure.

There had been considerable problems with the country's utilities, particularly with the quality of the electricity supply, added the staff representative. However, measures had been taken to improve the operational structure of ESCOM and the sustainability of its revenues and financing. In addition, action had been taken to secure privatization of the telecommunications sector.

Despite the negative short-term consequences of some of the measures necessary to reestablish macroeconomic stability, the authorities agreed that they were essential for economic growth, the staff representative noted. Real interest rates had been high at the beginning of 2000. A resurgence towards those levels had recently occurred and would likely remain with the continued tightening of monetary policy. Without such restrictive policies, however, the current macroeconomic environment would lend itself to a volatile inflation and exchange rates, further deterring foreign investment and private-sector growth.

On the growth outlook, the projection provided medium-term growth rates were assumptions that had been chosen to illustrate future debt ratios, the staff representative explained. Those assumptions had been moderated compared with the preliminary HIPC document. Given the need for stabilization in the short term and the problems of stimulating private-sector growth in the medium term the projections were realistic; but higher growth rates needed to be sought.

The Deputy Director of the Policy Development and Review Department stated that the lag between the start of the program and its discussion at the Board would normally be limited. The lag had been longer in the case of Malawi, but it still remained within the range of experience with other similar countries. The two reasons for the longer lag were, first, the time required to reach an agreement on the program and second and more substantively, a desire to align the test dates and the program year with the fiscal-year cycle.

On debt sustainability, the issue was not how to get to an NPV of debt to exports ratio of 150 at the completion point, but how to deal with failing to do so and ending up with a

higher ratio, the Deputy Director continued. The staff would analyze the significance of a NPV ratio of over 150 percent, the circumstances under which the ratio would become a concern, and the strategies to address an excessively high ratio, in the debt sustainability paper that was expected to be completed in early 2000.

The staff representative from the African Department commented that the participation of civil society in Malawi was an evolving process. Since attaining democracy in 1994, there had been considerable research on the country's poverty problem. Several papers had been published and a number of strategies developed and promulgated by the government in part reflecting input from civil society. However, poverty measures had been difficult to implement.

The staff representative from the World Bank added that there had been an extensive consultation process in Malawi over the so-called "Vision 2020" document, which had been the foundation for the Interim PRSP. One of the points that was extensively made by civil society representatives in Malawi, however, was that there was a great deal of consultation in the country but a lack of sufficient follow-up. Parliament, too, had become an extremely important player, particularly on matters of governance, and it was currently debating a public accounts committee report on corruption, the staff representative commented. It was fair to say that institutions were increasingly holding the government accountable across a range of issues, and that governance had been strengthened.

The Chairman wondered whether the Fund and the World Bank were jointly assessing the experience with civil society participation. Not everything derived from civil society would be constructive, and work would need to be undertaken to identify the good elements and contain the bad ones.

The staff representative from the World Bank responded that in designing the process for the full PRSP, the government had started by composing an issues paper and discussing it with donors, the Fund, and the Bank. The government had attempted to stress the substantive issues and also demonstrate on which matters it would be prepared to engage civil society. It was strongly encouraged that the government proceed in such a manner so that the consultation process with civil society would be feasible.

The staff representative from the African Department stated that the concern over the financing gap identified in the staff paper was expected to be filled by pledge that had been made by Paris Club creditors. The most important of these pledges was an understanding by the Japan authorities that all servicing commitments on outstanding Japanese ODA debt would be fully covered by grants. If these pledges were incorporated into the projections of outstanding debt, the net effect would be for Malawi to return to a NPV debt-to-exports ratio of 150 percent by the middle of the current decade or indicated in paragraph 52 of EBS/00/260. The sharp rise in the debt-to-export ratio in the shorter term reflected the sharp fallback in the volume of exports. With the ongoing measures of the Paris Club creditors, Malawi's debt burden should be declining in the next few years.

Mr. Rustomjee made the following concluding statement:

I thank Directors for their detailed comments and observations. I also thank the staff for answering the questions with such detail, for investing a considerable amount of effort in bringing the various documents to the Board, and for putting an enormous amount of work into providing substance to those documents.

Regarding the Interim PRSP and the PRSP process in moving forward, I welcome the favorable comments made with regard to the Interim PRSP, as well as the observations made as to what should be expected in the full PRSP. The concerns that I will discuss with the authorities from today's meeting include enhancing the issue of ownership in the final PRSP document, the issue of governance, the gender-poverty nexus, and the momentum of privatization. Better analysis needs to be undertaken into the causes and policies to address poverty and efforts need to be made to ensure that the monitoring arrangements for sustained participation are put in place in the final PRSP.

There were a number of suggestions that the PRSP should be less general and better focused on prioritizing major programs. Comments were made to transform the list of goals into priorities that are monitored and costed within the budget framework. That is a particularly valuable suggestion because I believe that it applies to every one of the HIPC cases.

I fully agree with the comments made about the need for a strategy to address the HIV/AIDS crisis. I do reiterate that the cost of effectively addressing the epidemic will be enormous. The resources needed to combat and reduce the prevalence of the disease are of a magnitude incomparable to many of the other issues raised earlier. It is not clear from where the necessary resources will be secured. Although it is important to include the completion point triggers on the HIV/AIDS issue in the PRSP, the targets prescribed must also be feasible.

I believe that the authorities will be happy to hear the comments on ensuring that the outcomes-based approach be continued in the full PRSP, as the Interim PRSP was produced on that basis.

I will convey to the authorities the concerns over diversifying exports, increasing the participation of small-scale farm holders in the agricultural sector, and improving the efforts and focus on the quality of services.

There was the issue of more vigorous parliament oversight. Our experience has been that there is a thin line between ensuring civil society input and being held hostage to the process. It is important to be sensitive to this as we move forward. I am plesed to receive advice that the authorities

should be balanced to the extent to which civil society participation takes place so that the process does not become paralyzed.

The details on the process of building a medium-term expenditure framework that extends to all of the ministries, given the recent availability of HIPC resources, will be conveyed to the authorities.

The foundation of the PRGF will be based on the principle of restoring and sustaining macroeconomic stability. That will be basis for any concerted effort at poverty reduction. Reducing inflation as an early priority, particularly, since it affects the poor directly, and strengthening expenditure control will all be discussed with the authorities.

A much firm stance will be taken in the PRGF process as we move forward on governance issues. I am pleased to note that Directors have recognized the steps that have been taken by the authorities on this so far.

The issue of full clearance of arrears will make it essential to exercise strict control over wage spending.

I also welcome the comments that Directors made about the willingness to reassess the issue of debt sustainability for Malawi at a later time, which demonstrates an understanding of the fact that this economy, like many others, is highly vulnerable to exogenous shocks. I agree with Directors that this should not be based purely on a number – 150 percent or any other number. At the same time, I would argue that it should not be an entirely definitional issue. We should not simply look at a rule that defines whether a country meets the condition or not. I value the staff's comments to examine this in a broader sense, as a collective set of issues, so that a reasonable answer can be found in the coming year.

I thank the Directors for agreeing to the decision point; the authorities will be delighted with this.

Chairman, this concludes my portfolio of decision point 2000 cases. I thank the staff for their work, not only in the case of Malawi, but also for all the countries in my portfolio. Although we have seen the full force of these endeavors in the last few months, particularly since the IMFC meeting, the work has been going on for much longer. Our authorities are very grateful for all the efforts. They also realize that there is a good deal of work ahead.

I also thank the bilateral creditors who have been very generous in providing assistance to my countries, and who have shown an increasing willingness to effectively provide write-offs of eligible debt. I acknowledge all of these efforts, as do the countries that I represent.

We are now moving into 2001. I hope that in 2001 we will have fewer papers, a more streamlined HIPC process, and a sharper focus on key issues. We have had the experience of coming to a Board meeting on one country and being faced with six papers. It has been confusing. I hope that more streamlining will be considered.

In 2001, we are moving from the first phase into the second phase of Fund-supported arrangements with Malawi. Based on the second phases that I have experienced with other countries, this will be more complex. We are moving from expressions of intent by the authorities to the second step of actually addressing poverty in substance. The second phase will require more flexibility and additional resources, especially in the way of technical assistance. As I have already mentioned, I feel uncomfortable about the extent and availability of the technical assistance needed. The challenges facing these countries are enormous and the efforts needed to escalate necessary technical assistance will also be considerable.

The year 2001 will reveal the need for greater data availability in these countries. Again, I am not sure from where the resources will come to produce that statistical information.

In 2001, we will have a clearer picture on three issues. First, the impact of HIV/AIDS will be significant, particularly, in the cases of Namibia, Swaziland, and Zimbabwe. The full impact of macro aggregates will be immense. Second, we will see whether the initial round of debt sustainability analyses have proved to be accurate. I hope that sensitivity will be shown if they should indicate otherwise. Third, we will see the extent to which non-Paris Club creditors are effectively able to make their contribution. Although I have no solutions to these three issues, I hope that flexibility and sensitivity will be afforded, as these events unfold.

Finally, I hope that in 2001 we pursue the remaining decision point cases as vigorously as we have done in the last few months.

The Chairman stated that he hoped that the acceleration of the HIPC process had created a momentum that would help to resolve the difficulties that might arise in the second phase, and lead to the continued pursuit of sound policies by the authorities, especially in the areas of corruption and armed conflicts on the African continent.

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

Executive Directors agreed with the thrust of the staff appraisal. Although Malawi's economic performance has improved in the latter half of the 1990s, they noted with concern that macroeconomic stability has proved elusive, growth has been inadequate, and a large proportion of the population

remains in poverty. While acknowledging Malawi's high vulnerability to external shocks, Directors observed that the country's economic problems have been compounded by occasional inconsistencies in the implementation of macroeconomic and structural policies, including the recent relaxation in monetary policy, which has contributed to currency pressures, and a resurgence of inflation.

Directors welcomed the authorities' renewed commitment to implementing a comprehensive stabilization and reform program, for which they are requesting Fund support under the Poverty Reduction and Growth Facility (PRGF). They noted that the program is appropriately based on sound financial policies, reprioritized public spending, deeper structural reform, and a comprehensive and cost-effective social safety net. In addition, Directors urged intensified action to arrest the spread and debilitating effects of HIV/AIDS.

Directors noted the ambitious inflation target under Malawi's economic program for 2000-01 and stressed that achievement of this target would require the steadfast implementation of policies. They urged the authorities to adhere firmly to agreed monetary targets. Directors also emphasized that monetary policy must be underpinned by continued fiscal restraint, with a target of achieving fiscal balance in fiscal year 2000-01. They observed that this would critically depend on the authorities' determination to resist pressures on wages and salaries and on other recurrent expenditure.

Directors agreed that much will be required from the new system for controlling and monitoring the expenditure of line ministries, since a repetition of the excess levels of commitments and consequential arrears of the recent past could derail the program. Directors also welcomed other elements of the 10-point plan of the Minister of Finance and Economic Planning to improve budgetary management, particularly the undertakings to eliminate nonemergency extrabudgetary outlays; increase fiscal transparency; invoke disciplinary measures under the new spending control mechanisms; and avoid the subsidization of maize or petroleum, which has caused substantial overspending in the past. They urged the authorities to improve expeditiously the monitoring and control of parastatals, and stressed the importance of improved targeting of government spending towards the poor, including food security, health and education. Directors welcomed the authorities' commitment to monitor and publish performance on a quarterly basis.

Directors welcomed the authorities' commitment to strengthen the structural reform program. They noted that the pace of privatization could be accelerated by improving the attractiveness of public sector assets to potential buyers through firmer action to liberalize markets and reduce cartelization, and emphasized the importance of enhancing competition in the financial

sector by fully privatizing the two dominant commercial banks with safeguards against connected lending. Directors also emphasized that the gains to small-holder agriculture from the liberalization of tobacco growing and marketing should not be put at risk by burdensome restrictions on tobacco buyers.

Directors welcomed recent initiatives to improve governance; including the strengthening of the offices of the Anti-Corruption Bureau, Department of Public Prosecution, Ombudsman, Auditor-General, and the Public Accounts Committee. They strongly urged the authorities to follow through vigorously on all investigations and prosecutions.

Malawi provides the core minimum data needed for surveillance and program monitoring. However, there are significant weaknesses with respect to the quality, timeliness, and coverage of economic statistics that hamper a more comprehensive assessment of economic developments. Directors urged the authorities to sustain efforts to improve data collection and dissemination, particularly in the area of fiscal statistics.

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

The Chairman made the following summing up of points relating to Malawi's request for a three-year arrangement under the PRGF; its Interim PRSP; and its decision point under the enhanced HIPC Initiative:

Interim Poverty Reduction and Strategy Paper (Interim PRSP)

Directors agreed that the interim PRSP provides a sound basis for concessional lending by the Fund and adequately outlines the process for the development of a full PRSP in a broad-based participatory manner. They welcomed the authorities' schedule for completing the PRSP by mid-2001 and commended the general framework for poverty alleviation in the interim PRSP, including its focus on macroeconomic stability, effective public services, private sector development and export diversification, social safety nets, and steps to address the HIV/AIDS pandemic. Directors noted that further analysis would be needed before completion of the full PRSP, so that interventions could be costed and prioritized, and core targets and monitoring developed. They observed that the authorities' program was ambitious and that they would need to devote time and resources to develop a high quality strategy to put the economy on a sound footing.

Poverty Reduction and Growth Facility (PRGF)

Directors supported the objectives of the authorities' economic program, and agreed with the framework for achieving these objectives, which

aims at reducing monetary growth, establishing a balanced fiscal position, improving spending control, deepening structural reforms, strengthening governance, and prioritizing pro-poor expenditure. In light of previous slippages in fiscal policy, Directors emphasized that their support for the program depended on the successful implementation of the new commitment control system and the avoidance of further payments arrears. They also stressed that intervention in maize marketing and subsidization of petroleum should not be resumed. Directors welcomed the authorities' initiative in establishing a parastatal enterprise reform and monitoring unit in the Ministry of Finance. They commended the progress made in tax administration, including the establishment of the Malawi Revenue Authority, and looked forward to an early extension of the surtax to wholesale and retail stages. The authorities' commitments to improved targeting and reporting of government spending towards the poor, and to the monitoring and publishing of performance on a quarterly basis were welcomed.

The authorities were urged to take steps to improve competition in the banking sector and to reduce the burden of the high reserve requirement ratio on commercial bank deposits, when liquidity conditions permit. Directors also emphasized that the gains to small holder agriculture from the liberalization of tobacco growing and marketing should not be put at risk by burdensome restrictions on tobacco buyers.

Directors underscored the importance of improving governance. Outstanding cases of corruption, fraud, abuse of office and misappropriation of public funds should be pursued vigorously.

Enhanced Initiative for Heavily Indebted Poor Countries (HIPC) - Decision Point

Directors agreed that Malawi has reached the decision point under the enhanced HIPC Initiative. They agreed that Malawi would reach its floating completion point when the conditions contained in Box 2 of the HIPC Decision Point Document (EBS/00/260) have been met, and that interim assistance should be provided by the Fund in the period up to the completion point. Directors noted that they would attach particular importance to Malawi's satisfactory implementation of the PRGF-supported program, in view of the country's uneven track record on macroeconomic stabilization in the past. On governance, Directors stressed the importance for Malawi to build upon the substantial steps already taken in order to improve its record substantially. A number of Directors expected that, in addition to the trigger on the separation of the fiscal management and audit functions, and the independence of the Auditor-General, Malawi would, at the time of reaching its completion point, also have taken action on other important aspects of governance, including prosecution procedures and procurement methods. Directors also stressed the need for effective monitoring of the use of interim

assistance, and more emphasis on public sector and labor market reform. They welcomed the mechanisms which had been put in place to ensure a timely and transparent monitoring of expenditures, including those funded from debt relief under the HIPC Initiative, and stressed that further strengthening of these mechanisms should remain a government priority.

Directors observed that, even after assistance under the HIPC Initiative, Malawi's external debt situation will remain fragile, underscoring the need to further diversify the economy and exports, and to pursue prudent debt management policies. Several Directors were prepared to consider that Malawi's debt sustainability, including the options for additional assistance, be reassessed at the completion point.

The Executive Board took the following decisions:

1. The Government of Malawi has requested a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in a total amount equivalent to SDR 45.11 million.

2. The Fund determines that the interim Poverty Reduction Strategy Paper (PRSP) for Malawi set forth in EBD/00/117 (12/7/00) provides a sound basis for the development of a fully participatory PRSP, for reaching the Decision Point under the enhanced HIPC Initiative, and for Fund concessional assistance.

3. The Fund decides to approve in principle the three-year arrangement set forth in EBS/00/263, Supplement 1 (1/5/01). The approval of this arrangement shall become effective on the date on which the Fund decides that the World Bank has concluded that the Interim PRSP submitted by Malawi provides a sound basis for the development of a fully participatory PRSP, for reaching the Decision Point under the enhanced HIPC Initiative, and for World Bank concessional assistance. Upon the approval of the arrangement becoming effective, Malawi may request the first disbursement under the arrangement, on the condition that the information provided by Malawi on the implementation of the prior actions specified in Table 2 of the Memorandum on Economic and Financial Policies attached to the letter dated December 8, 2000 is accurate. (EBS/00/263, Cor. 1, 12/20/00)

Decision No. 12377-(00/129), adopted
December 21, 2000

Enhanced Initiative for Heavily Indebted Poor Countries—Decision Point

1. Based upon the external debt sustainability analysis for Malawi (EBS/00/260, 12/7/00), the Fund, as Trustee (the "Trustee") of the Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and

Interim PRGF Subsidy Operations (the "Trust"), established by Decision No. 11436-(97/10), February 4, 1997, decides that:

(i) in accordance with Section III, paragraphs 1 and 2 of the Trust Instrument (the "Instrument"), Malawi is eligible and qualifies for assistance under the enhanced HIPC Initiative as defined in the Instrument.

(ii) the completion point for Malawi will be on the date when the Trustee determines that:

(a) Malawi has satisfactorily implemented the policy reforms described in paragraph 61 and Box 2 of Malawi's decision point document under the enhanced HIPC Initiative (EBS/00/260, 12/7/00);

(b) Malawi has a stable macroeconomic position and is satisfactorily implementing its Fund-supported program; and

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

(iii) the external debt sustainability target for Malawi is 150 percent for the present value of debt-to-exports ratio.

(iv) in accordance with Section III, paragraph 3(a) and 3(b) of the Instrument, the equivalent of SDR 23.14 million of assistance shall be made available by the Trustee to Malawi in the form of a grant to permit a reduction in the net present value of the debt owed by Malawi to the Fund.

(v) in connection with the interim assistance contemplated under Section III, paragraph 3(d) of the Instrument,

(a) satisfactory assurances have been received regarding the exceptional assistance to be provided under the enhanced HIPC Initiative by Malawi's other creditors, and

(b) the Trustee shall disburse to Malawi as interim assistance the equivalent of SDR 2.314 million to an account for the benefit of Malawi, established and administered by the Trustee in accordance with Section III, paragraph 5 of the Instrument; and the proceeds of the grant shall be used by the Trustee to meet Malawi's debt service payments on its existing debt to the Fund as they fall due, in accordance with the following schedule: 42.8 percent of each repayment obligation falling due until December 31, 2001.

(vi) in accordance with Section III, paragraph 3(e) of the Instrument, the Trustee shall disburse the remainder of the assistance committed to Malawi under paragraph (iv) of this decision at the completion point, together with interest on amounts committed but not disbursed during the interim period, calculated at the average rate of return per annum on investment of resources held by or for the benefit of the Trust.

2. Paragraph 1 above shall become effective on the date on which the Fund decides that the World Bank has concluded that the Interim PRSP provides a sound basis for the development of a fully participatory PRSP, for reaching the Decision Point under the enhanced HIPC Initiative, and for World Bank concessional assistance. (EBS/00/260, Sup. 1, 12/20/00)

Decision No. 12378-(00/129), adopted
December 21, 2000

2. TURKEY—STAND-BY ARRANGEMENT—REVIEW, AND MODIFICATION OF PERFORMANCE CRITERIA; AND SUPPLEMENTAL RESERVE FACILITY

The Executive Directors considered a staff paper on the third and fourth reviews under the Stand-By Arrangement for Turkey and its request for modification of performance criteria; and Turkey's request for the use of Fund resources (UFR) under the Supplemental Reserve Facility (EBS/00/273, 12/18/00; Cor. 1, 12/20/00; and Sup. 1, 12/19/00)

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

Overview

Turkey will continue implementing policies that will reduce inflation to single digits by 2002, ensure a sustainable fiscal position, cure structural inefficiencies, and raise the level of sustainable growth. The primary goals of policies in 2001 are to achieve the inflation target, improve the external position, and strengthen the banking sector.

During its first year, program implementation has been broadly on track. Fiscal policy has been substantially tightened. Inflation and interest rates have declined rapidly. So far, all performance criteria have been met. But difficulties recently emerged in the banking sector, and the current account deficit has exceeded the program's assumptions.

Towards the end of November the weaknesses of the banking sector gave rise to a rapidly snowballing liquidity crisis. It led to a substantial loss of foreign exchange reserves, high interest rates, bank losses, and a falling stock market. The pressures on Turkey's financial markets eased only with the government's announcement of strengthened policies and its request for access to the Supplementary Reserve Facility.

Vigorous steps have been taken to reinforce the program. They include a further tightening of the already strong fiscal policy, decisive measures to correct problems in the banking sector, an acceleration of privatization and other structural reforms, and stronger incomes policies. All prior actions required for tomorrow's Board meeting have been completed.

Macroeconomic Developments

This year, CPI inflation is expected to drop to about 38 percent from last year's 69 percent. This represents considerable progress, but falls short of the program target of 25 percent. It also caused a real appreciation of the exchange rate.

Output is expected to grow about 6 percent this year, following last year's 6.1 percent decline after the devastating earthquake and the Asian and Russian crises. The sharp decline of interest rates stimulated consumer demand and imports. This, and higher oil prices, caused a deterioration of the current account, which will run a deficit of about 5.3 percent of GNP this year. The strong demand also put upward pressure on inflation.

Next year, growth is expected to slow to around 4 percent, due to the 2 percent of GNP fiscal tightening and the recent increase in interest rates. Likewise, the current account deficit is expected to narrow to about 3.5 percent of GNP.

Fiscal Policy

Turkey's fiscal performance remains strong and provides the anchor of the program. The public sector will record a primary surplus of 3 percent of GNP this year, almost 5 percent above last year's level. Next year the primary surplus should increase further to 5 percent of GNP. To achieve this, the government has already taken measures, mostly revenue measures, yielding to 3.5 percent of GNP. This early action has boosted the credibility of the budget. The government's implementation of unpopular fiscal measures of such magnitude two years in a row shows its determination to attack Turkey's longstanding economic imbalances.

Structural Reforms

The government has accelerated its implementation of structural reforms. One-third of Turk Telecom, to which strong management rights are attached, and a majority of the shares of Turkish Airlines, are for sale. The government is confident that these offers will attract strong interest from foreign investors, and can be completed by March 2001.

The electricity market will be reformed in depth. A draft law now before parliament calls for divestiture of state assets in the electricity sector and establishes a regulatory framework for promoting competitive markets. The authorities know that privatization will promote productivity and investor confidence, and that its proceeds will help finance the balance of payments and the fiscal deficit.

The reform of agricultural policies is well advanced. Indirect support policies will be replaced by the end of 2002 with direct income support. This will increase the efficiency of agriculture, and reduce the costs of assistance to farmers while protecting the poorest. Price supports have already been substantially reduced. The State Economic Enterprises in this sector will soon be privatized. At least six sugar refineries will be transferred to the Privatization Agency's portfolio and are expected to be sold by the end of 2001. Also, by the end of January 2001, the state's tobacco processing facilities will be transferred to the Privatization Agency.

Banking

Banking regulation and supervision have made good progress since the beginning of the program, especially since the Banking Regulation and Supervisory Agency (BSRA) was set up. But as the recent turmoil shows, further actions are required to eliminate the weaknesses of the banking system and promote confidence. The authorities recognize the weaknesses of the system and are implementing comprehensive reforms to limit the need for government intervention and minimize the risk of contagion.

The strategy rests on several pillars. First, in order to ensure the banking system's continued access to domestic and foreign funds, the government has undertaken to protect all bank depositors and creditors. Second, to encourage the consolidation of the banking system, tax obstacles to bank mergers have been removed. Third, the BRSA is speeding up the resolution of the 11 banks it has taken over. Eight of these banks are now offered for sale, and the fate of those not sold will be resolved by September 2001. Fourth, banking supervision is being further strengthened. The BRSA is closely monitoring developments in the sector and is ready to intervene whenever required. The program also calls for stronger regulations of internal risk management, lending to affiliates, and full tax deductibility of loan loss provisioning.

Monetary and Exchange Rate Policy

Monetary policy will aim at recovering part of the foreign exchange reserves lost during the turmoil, while avoiding an excessive increase in total base money creation. During the first half of 2001, the monetary and exchange rate framework will remain based on a pre-announced exchange rate path with

no band. Then, beginning July 1, 2001, a gradually widening band will be introduced around the pre-announced exchange rate path. This band will continue to widen during 2002, giving the central bank more flexibility in controlling NDA. Meanwhile, an inflation targeting framework will guide policies. To achieve the inflation target, the central bank may keep NDA growth tighter than planned.

The authorities have resisted abandoning the present exchange rate regime, choosing instead to reinforce their policies and boost the credibility of the program and of the peg itself. The consequences of a float would have been disastrous. The disinflation program and its achievements would have disappeared overnight, with severe damage to the banking and corporate sectors. And the credibility of the economic and political leadership, which depends on the exchange rate commitment, would have been seriously damaged. The staff report also points out that the worsening of the current account deficit appears to stem from economic overheating rather than from competitiveness problems, as shown by the behavior of tourism revenues, the volume growth of exports, and unit labor costs.

Financing Needs and Private Sector Involvement

To secure private sector assistance in resolving the crisis, the authorities arranged meetings with senior representatives of international banks in Frankfurt (December 10) and New York (December 13). In these meetings the Turkish officials outlined the measures they had taken to strengthen the program, and asked the international banks to support the program by maintaining their credit lines to Turkey. The banks participating in these meetings welcomed the strengthening of Turkey's program and signaled their intention to maintain their support for Turkey, and this intention is indeed being carried out. Since the meetings, the rollover rate of credit lines has been slightly over 100 percent. Moreover, the Turkish Treasury today reached agreement with a group of 11 international private banks on a six-month syndicated loan in the amount of $1 billion. The Treasury has an early repayment option and the cost of the loan will be libor plus 2 percent.

Next year Turkey's gross external financing needs will be considerable. Obligations to repay maturing medium- and long-term debt amount to $16.9 billion. The current account deficit is estimated at $7.6 billion,. In addition, Turkey will need to roll over short-term external debt now totaling about $27 billion, and restore its reserves. In total, Turkey's gross financing needs will exceed $50 billion. Turkey's continuing strong commitment to the program, its financing needs - including the requirement to maintain adequate levels of reserves under the present exchange rate regime, and the need to enhance market confidence - fully justifies the requested access under the SRF in addition to the existing Stand-By Arrangement.

Mr. Faini submitted the following statement:

The November crisis did not come from out of the blue. The combination of a burgeoning current account deficit and a weak banking sector was instrumental in undermining investors' confidence and precipitating the crisis. Lack of confidence could be detected already during the first half of the year from the stubbornly high levels of long-run interest rates and the surge of import demand. At the same time, it cannot be denied that the authorities' commitment to the program had been by and large relatively strong, at least until the summer, as witnessed by the fiscal consolidation and the number of prior actions that were implemented in the field of structural reforms. However, the delay in undertaking strong fiscal action to contain the rising current account deficit, the slowing down in the implementation of key structural reforms, and, lastly, the liquidity injection on occasion of the crisis, have all shown a weakening of the authorities' resolve. In this context, we are reassured to see from Mr. Kiekens and Mr. Cakir's helpful preliminary statement a renewed pledge of the Turkish authorities toward the success of the program.

Lessons from the crisis

The main lesson from the November crisis is, I believe, quite clear. Fixed exchange rate regimes are extremely vulnerable to changes in investors' sentiments and to slippages in economic policymaking. Floating regimes are in this respect more forgiving: policy slippages are punished only gradually, and can be remedied with more limited costs. The November crisis shows also that the IMF can react quite promptly to an incipient crisis. Staff should be congratulated for preparing in a very short period of time and under very difficult circumstances a program that is certainly not deprived of risks, but if fully adhered to may restore confidence and macro stability to the Turkish economy. For this to happen, however, the authorities commitment to the letter and the spirit of the program needs to be unflinching. In particular, the authorities must stand ready to take promptly all necessary corrective actions if the international environment takes a turn for the worse or if some of the key areas of the program prove to be weaker than required.

The Banking Sector

This has been the Achilles' heel of the program. This fact is not surprising in view of the recurring history of banking crises in the Turkish economy. The key question is whether the envisaged measures are sufficient to bring the program back on track in this regard and prevent financial weaknesses from spilling over once again to the balance of payments. We are only partly reassured by the measures adopted in this area.

The guarantee extended to both depositors and creditors. This is obviously designed to reassure all classes of investors and stem the outflow of capital. It has been used in other circumstances, namely in East Asia. On those occasions, however, it was accompanied by an agreement to consolidate existing liabilities, a feature that is missing from the Turkish program. Furthermore, the legal basis of the guarantee is left unclear. While it is true that in the past the Turkish government has provided a de facto guarantee to creditors and depositors, this has been done, as noticed by staff, in a non-transparent and ad hoc way. It is essential that past mistakes in this field not be repeated. The absence of clarity on the legal underpinnings of the depositors' and creditors' protection can bring the worst of both worlds: moral hazard problems are maximized, but the lingering uncertainty about the guarantee fails to reassure foreign and domestic investors. Equally crucially, the authorities need to be quite specific about the scope of the guarantee. Does it apply to all creditors, including those that have entrusted financial institutions with asset management responsibilities? We also wonder why the announcement of the details of the guarantee has been delayed until mid-January. Are there good reasons to do so? Finally, and perhaps even more crucially, the guarantee introduces a substantive contingent liability for the budget, which would come on top of the already large costs arising from the banking sector recapitalization.

The vulnerability of the financial sector to maturity and currency mismatches. The staff annex is very candid in acknowledging the significant vulnerabilities of the financial sector. The November crisis shows that even in the context of an exchange rate-based disinflation program maturity mismatches can be a substantial source of vulnerability. Ironically, those banks that were hard hit on this score were those that gambled on the success of the program, namely on the convergence of interest rates. This is not to underestimate the risks posed by currency mismatches. The fact that a substantial portion of the bank's forward contracts may be placed with connected or unconnected corporate entities is extremely worrisome. There is indeed the risk that a currency crisis may spillover to the corporate sector and may then feed back again, if firms are unable to meet their commitments, to the financial sector. The analysis of counterparty risk should therefore be a major priority in the supervision activity of the BRSA. Staff indications on how the BRSA is planning to deal with the monitoring of such a risk would be welcome.

Measures to deal with connected lending. The original program envisaged a phased reduction in the limit of loans to large borrowers from 75 percent to 25 percent of the bank's capital. The schedule for implementing such a measure was however arguably too slow. We would like to know staff views on whether a more accelerated schedule to implement such a measure would be desirable and feasible.

The commitment of the authorities in the banking sector restructuring. Delays in this field have been crucial in undermining investor confidence. To reaffirm their credibility, it will be important for the authorities to strictly adhere to the steps – even the most painful – envisaged in the bank restructuring plan. The liquidation of some banks, in case it is necessary, will be the true test, vis-à-vis the markets, of the authorities' commitment.

The Exchange Rate Regime

In view of the persisting weaknesses in the financial sector and the large contingent liability on the budget, we would have preferred a more flexible approach to the exchange rate regime. At the same time, we understand the point of view of the Turkish authorities that a shift to a flexible regime during the November turmoil could not have been undertaken in an orderly way. However, while the large financing package, the enhanced guarantee to depositors and creditors, and the additional fiscal consolidation have so far succeeded to some extent in restoring investors' confidence, some of these measures may also work to enhance the cost of a future crisis. Indeed, the blanket guarantee to depositors and investors may well aggravate moral hazard problems, further weaken the banking sector, and burden the public sector with a potentially very large liability that would be called upon at the very same time as a currency crisis. Under these conditions, a disorderly exit from the present exchange regime could turn out to be extremely disruptive. It is essential therefore that staff and the authorities work expeditiously toward creating the conditions for a smooth shift to the floating regime that will be gradually implemented starting in mid 2001. This means first and foremost defining a new monetary framework. We welcome in this respect the somewhat belated decision by the Central Bank to gradually adopt an inflation-targeting framework. The independence of the Central Bank is central in this respect. Very appropriately, the enactment of the related central banking law is a structural performance criterion under the program. The fall of inflation toward low two-digit levels should facilitate the adoption of an inflation-targeting framework. The key condition to ensure a smooth transition is however the strengthening of the banking sector. During 2001, the exchange rate will move along a very tight corridor, with the exchange rate guarantee coming on top of the blanket guarantee for creditors and depositors. Under these circumstances, the risk of opportunistic behavior in the financial sector will be magnified. Strengthened supervision by the BRSA will be essential to limit the scope for such behavior.

The Privatization Program

This is a key area, as it both signals the commitment of the authorities to press ahead with the structural component of the program and it provides a valuable source of foreign exchange as well as an additional reduction in the borrowing needs of the government. However, we are somewhat puzzled by

some aspects of the authorities' commitments in this area. For instance, in the case of telecommunications, the authorities have announced their intention to make available one third of the shares of Turk Telecom to a strategic investor, with transfer of "strong" management rights. What "strong" management rights means is however left unspecified. We are concerned that the Turkish government may wish to retain a veto right on the decisions of the new management. If this were the case, it could severely weaken the interest of foreign investors in Turk Telekom, even more so in light of the marked slowdown in international telecom markets. Similar issues arise in connection with the privatization of Turkish Airlines.

Debt management strategy

In light of the relevance of public debt and of its significant external component, we would have appreciated a more extensive treatment of the debt management strategy. It is true that public debt management has succeeded in lengthening the average maturity of domestic debt, but this was mainly achieved by increasing the issuance of floating rate notes. This instrument, while providing some protection against rollover risk, fails however to eliminate the vulnerability of the budget to interest rate fluctuations. More crucially, we are concerned about the persistently high share of foreign currency denominated public debt, a factor that highlights the substantive risk to the budget from an exchange rate devaluation.

The Role of Income Policies

We remain puzzled as to the role of such policies in the Turkish program. According to staff, insufficient attention to income policies has been "one of the key weakness of the program and one that has to be remedied soon to bring inflation down more rapidly." However, no concrete steps are described in the LOI, except for a somewhat vague reference to a more active governmental role in the dialogue between government and social partners and in the pricing decisions of firms. Moreover, the emphasis on the need for more active income policies stands in sharp contrast with the staff assessment in previous reviews that underscored the flexibility of the Turkish labor market. Has staff modified its assessment in this area? Is there any evidence showing that excessive wage growth was a substantive factor in slowing down the disinflation process? Or does the problem lie in the pricing decision of firms and in their pervasive market power? What are the concrete steps that staff is suggesting to the authorities to allow a smoother functioning of the labor and the product markets? In addition, is there a risk that an unwarranted intervention by the authorities in the pricing and wage determination process may perversely undermine the credibility of the disinflation program? We would submit that the role of the government in income policy should first of all to lead by example in setting wages in the public sector.

To sum up, we concur with the staff appraisal that the risks ahead remain significant. Failure or even hesitation to maintain the policy momentum and fully carry out the program may again shake investors' confidence and force an abrupt exit from the present exchange rate regime. The consequences would be extremely disruptive, even more so than in the recent past, due to the large contingent liabilities on the public sector and the persistently weak financial sector. It is essential therefore that the authorities demonstrate an unwavering commitment to the program. We wish them full success in their endeavors.

Mr. Collins submitted the following statement:

At the outset I wish to commend staff—and management—for their prodigious efforts, in conjunction with the Turkish authorities, to prevent a crisis from turning into disaster. The jury is still out, of course, but the program under consideration today at least sets out a plausible basis on which to restore equilibrium in the Turkish banking sector and in the economy more generally. But we should be under no illusions: the program clearly faces substantial risks, not least in terms of political will to implement painful reforms and the vulnerability of the exchange rate peg.

I begin from the proposition that the primary aim of the program is to provide on opportunity for banking reforms, so as to leave banks in a healthier position when Turkey moves to a more flexible exchange rate regime. In that context, my remarks will focus on macroeconomic policy and banking sector reform; and I shall also have something to say on PSI.

Macroeconomic policy

The interaction between monetary policy and banking reform is a key concern, which the program should address more fully:

The program recognizes that foreign exchange risk remains in the banking sector, but does not suggest a convincing strategy for winding down positions (without triggering a further currency crisis). The program needs to be stronger on how balance sheet weaknesses are to be addressed. Attention needs to be paid by financial supervisors to (a) ensuring banks are less opaque about their hedging – for instance, understanding the group ownership of many Turkish banks, which provides banks with a way to pretend that their positions are hedged when they are not, and (b) preventing banks from building up unhedged net open positions, as well as dealing with them once they have arisen.

Banking reform holds the key to a credible monetary policy. It is hard for the CBT to tighten monetary policy enough to squeeze inflation (and its

expectations) out of the system, since the banks are subject to massive interest rate risk (as we have seen).

A strong message must be given to the CBT that its role should be to conduct monetary policy, and not to save banks. Its provision of liquidity to save banks in the recent crisis was, to say the least, an unhelpful departure from its monetary policy objectives.

The original program's monetary policy plans have been blown off course by the crisis. In these circumstances, I was disappointed to see little evidence in the new program of accelerated planning for movement to the planned eventual inflation targeting regime. Steps to achieve this could include:

moving faster on operational independence for the CBT, and improvements to data;

early and visible work on identifying Turkish monetary transmission mechanisms – and whether they are changing in a lower-inflation environment; and

re-examining prices and incomes policies, without which inflation targeting could prove very difficult (I understand, for example, that there is a degree of backward indexation in some public sector wage agreements).

Given the risks to the program – and particularly to the peg – this kind of swift planning would also help Turkey prepare for a further crisis, which could require a rapid switch to a new monetary policy.

Whilst being broadly content with the further consolidation of fiscal policy entailed in the program, I would emphasize that:

Continued strong progress on fiscal consolidation is essential for the success of the program – in terms of disinflation, a lower fiscal deficit (with its implications for debt dynamics), and cooling import demand. If interest rates do not fall soon, there could be worrying implications for debt service expenditure, and for the banking sector. The program needs to be explicit about these risks and plan a contingency in case they occur.

If events suggest the need for further fiscal consolidation, the authorities should move quickly. As well as increasing electricity tariffs, they should also look at reversing the cuts in the rate of petroleum consumption tax which were made to soften the blow of higher oil prices, rather than just increase this tax in line with inflation.

Banking sector reform

My first set of concerns in this area is about the supervision and regulation of the large number of 'healthy' banks which are not under SDIF control. In a number of areas, the program raises important concerns without setting out a full strategy for addressing them. This could jeopardize our ability fully to monitor their progress in the coming months. In particular:

A consistent, comprehensive and regular audit needs to be undertaken of bank balance sheets and the risks they carry. The banking system remains fragile as a result of high interbank exposures. Such audits would illuminate this, and could also provide the authorities with a more systematic tool for deciding which banks need to be taken into administration.

Whilst supervision has improved, it does not yet meet Basle standards. Early progress needs to be made on this. Focusing on issues like capital adequacy is a good start, but leaves many risks uncovered. Improvements of this kind could be a valuable program benchmark. There also needs to be a strong focus on implementation in supervisory and regulatory reform, and I am concerned that the only milestone on this subject is for the authorities to adopt new regulations, rather than to implement them (action 11, page 42).

The program notes that investment banks have accumulated large derivatives positions, despite the small size of the investment banking sector. However, there is no action suggested to address this, and this is a lacuna that needs to be addressed.

Turkey is chronically over-banked. Action needs to be taken to encourage consolidation within the sector. The program notes this problem, but suggests nothing more than waiting for banks to fail and then letting the SDIF deal with them. Political support is needed to allow the regulator decisively to close down banks that are failing (at the moment, banks' political connections often prevent this from happening); the tax incentives for mergers need to be properly implemented; and there should be no political pressure against a reduction in the bank sector workforce.

Underpinning all this, I hope that the new regulatory body–which has been doing a good job in difficult circumstances–will be given all the resources and political support it needs to take these further difficult steps.

Tighter supervision would go some way to meeting my second concern – the open-ended guarantee of Turkish bank liabilities, which could provide banks with the incentive to continue their unhealthy practice of borrowing abroad to play the markets at home. But the chance of this happening could be further reduced if the prospectus clarifying the nature of the guarantee (due end-January 2001) provided a concrete timescale for its

dismantling, fitting in with the program's milestones for resolving banking sector difficulties.

Third, swifter action should be taken to resolve the banks in SDIF administration. This should be a key part of the program. In particular:

The September deadline for the resolution of banks with no buyer interest is too late; a much earlier date should be possible.

The authorities will know at the end of January which banks have attracted serious buyer interest; at this point, they should agree to resolve those with no buyer interest, and make a public statement to that effect.

Private sector involvement

Private sector flows are clearly an important element of this program. We will therefore need a good feel for whether the private sector is maintaining sufficient flows, on a month by month basis. This means that some benchmarks will be needed of the sort of private flows we would expect to see, month by month, to enable us to assess this element of the program. The Staff Report does not, however, provide this information. Table 4 (page 39) comes closest. But these annual figures would need to be broken down into required flows for each month of 2001 in order to meet this need. I would therefore be grateful if such a breakdown could be provided and monitored accordingly.

One element of this private finance is the rollover of interbank lines, where the need for this information can be illustrated. The Turkish authorities have requested a voluntary rollover of these lines, which is working well at the moment (given the guarantee of bank liabilities, however, this is not a strong form of PSI). Proper review of this operation requires more than just daily information on rollovers – which we are getting; it also requires benchmark information on what we would hope to happen.

Other

On privatization, I share staff concerns that the program should stay on track. The Turkish authorities should set out their stall more clearly on what they are going to privatize beyond Turk Telecom and THY (Turkish Airlines). And in any further privatizations, they will need to be much clearer about management rights.

Finally, it is worth noting that the Turkish authorities have made significant progress on some difficult issues – such as pension reform, and duty losses in the state banks. I see this as evidence that substantial and

painful reform of the kind advocated above (e.g. on banks) is possible in Turkey, given the political will.

Conclusion

It is exactly a year since the Turkish SBA was approved, with high hopes given its radical elements, but with awareness of the significant risks which attended it. In the event, crisis struck from an unexpected quarter; and so far, as the Staff Appraisal candidly puts it, the authorities have had a narrow escape. That the Fund is prepared to grant an SRF of 600% of quota is proof enough that the international community is willing to meet its responsibilities. It is now up to the Turkish authorities to justify the faith we are reposing in them by taking the difficult measures necessary to make this program work.

Mr. Wijnholds submitted the following statement:

Turkey recently experienced a financial crisis while under a program with the Fund. In a sense, Turkey's situation resembles that of a patient in a hospital who, while recovering from an illness, suffers a stroke. He is certainly better off suffering a stroke in a hospital, where he is more likely to receive quick, life-saving treatment than elsewhere. Because Turkey is already under a program, the Turkish authorities and the IMF have been able to respond quickly in putting together an enhanced program that could be supported by an emergency loan to alleviate the immediate crisis. This situation, however, raises a question: Since the patient was already under treatment, could it not have been possible to prevent the stroke? Was the initial treatment ineffective? Generally, we do not believe that the patient received bad treatment or advice. It is more likely that the patient did not fully follow the prescription given by his doctors. In today’s environment of freer capital movement, in order to implement a successful macroeconomic policy, a country must have a sound financial system, particularly a strong banking system. Turkey has for the most part performed well under the SBA, but it has fallen short regarding bank streamlining and other structural aspects of the program. An unstable banking system and a non coherent and fragile macroeconomic framework have been transformed into a banking panic and banking collapse. In Turkey's case, this translated immediately into a weakening of confidence. We recognize the urgency and depth of Turkey’s difficulties and are thus prepared to go along with the envisaged rescue package.

Having said that and before moving to some of the program’s aspects in more detail, I wish to record some hesitations on the size (600% quotum under the SRF alone) and phasing of the proposed arrangement, as well as on the exchange rate component of the adjustment strategy. The following are my three main concerns: (1) on procedure, notwithstanding the importance of

swift IMF-intervention in the resolution of the Turkish crisis, my authorities and I regret the limited format of the informal consultation process. This holds particularly true given the huge size of the package and the substantial exposure of non G-7 countries' banks on Turkey. For these same reasons, we feel that only a one-day preparation of this Board meeting is too short. (2) The staff paper confirms that the current crisis has not so much been caused by external developments, as by slippages in the monetary, fiscal, banking system and privatization fields. In light of this track record, and given the substantial downside risks to the program, we feel that the monthly program monitoring as suggested by staff, should be extended until at least the end of 2001. Moreover, given Turkey's poor track record, we question the wisdom of the proposed heavy frontloading (under the SRF alone four disbursements equaling 420% of quotum in the first four months, as opposed to three disbursements equaling 'only' 180% of quotum in the remainder of 2001). This phasing seems also at odds with the guidelines on phasing, which state that 'the purchase dates would also be distributed as evenly as possible throughout the arrangement'. (3) I believe that the provision of more accurate information on Turkey's reserves could have enhanced the Fund's ability to prevent the crisis.

Foreign exchange strategy

Given Turkey's history of high and persistent inflation, the introduction of (a quasi) currency board in late 1999 indeed seemed a possible adjustment approach. The experience during 2000, however, shows that the Turkish authorities, although willing to reap the benefits of exchange rate stability, have underestimated the associated costs of the arrangement (i.e. the possibility of endogenous interest rate increases and the need for complementary action on the front of the banking system, privatization and wage determination). This has seriously damaged the credibility of the exchange rate commitment, and has prevented the envisaged decline of inflationary expectations.

In this light I am looking forward to the authorities' implementation of their plan to gradually make monetary and foreign exchange polices more flexible starting July 2001. I also welcome the authorities' intention to enhance central bank independence and move toward an inflation targeting framework. With regard to the width of the foreign exchange band, given the competitiveness difficulties, we feel that the annual widening of the band by 15% (implying only 7.5% additional depreciation each year; insufficient even to compensate for the inflation/depreciation rate differential) should be enlarged.

While the NIR targets provide a degree of assurance that Turkey will not use the proceeds of Fund purchases for intervention, these targets are initially set on a monthly basis and thereafter on a quarterly basis. Therefore,

in this particular case it is important to consider the NIR floor unbreachable and not subject to a waiver in case developments are not as favorable as expected.

Banking sector and privatization

The main problem in the Turkish banking sector is the one-sided focus on investing in high-yielding treasury bills, funded by short-term (foreign exchange) deposits. Although the staff proposes measures to address this problem, we feel that it is crucial that banks have sufficiently strong incentives to limit their foreign exchange exposure. Furthermore a speedy resolution to the intervened banks is crucial. The guarantee of credit lines to banks is helpful, but, like the guarantee of deposits, it has negative implications in the long run, because it enables weaker institutions to attract funds by offering higher interest rates, which prevents the stronger banks from using their competitive advantage.

Progress in privatizing the airline company and the other state-owned firms in the telecommunications and energy sectors is crucial to enhancing investor confidence, strengthening public finances, and improving prospects for productivity growth. A timetable has been announced for the sale of a third of the shares in the Turk Telecom. I believe that the new terms established to transfer stronger management rights are likely to attract potential investors, resulting in a successful privatization.

Data on reserves

Information on foreign exchange reserves is an area where I believe the staff could have been more ambitious in providing information about reserves in its reports, particularly in UFR-cases. The Turkey staff reports over the last twelve months have only reported a gross reserve figure and a Net International Reserve figure for program purposes (often buried in an annex). In this context it is striking that, in a program where the cornerstone is a (crawling) pegged exchange rate regime, the Board is not informed about the level of liquid usable reserves available for intervention. We should always be provided with staff's best estimate of what is usable, even if "usability" doesn't always have a uniform definition. In addition, for a country that subscribes to the SDDS and has a reserve template, it would be useful to provide some of this information in the staff report, including the gross reserve level, the shot-term drains (i.e. everything falling due within one year), the contingent liabilities and the possible off-balance sheet exposure. Furthermore, being precise about the composition of reserves is important as a reserve accumulation target partly determines our definition of 'gross financing need' and thus the size of IMF financing. If the liquidity of reserves is insufficient and the actual level lower than we thought, the implication may be more Fund financing. In the case of Turkey while reserve levels are

roughly where they were a year ago, their liquidity was insufficient, resulting in the need for the Fund to provide additional financing of $7.5 billion as opposed to the $3.6 billion approved in December 1999. Finally, on this topic, I wonder why the so-called Dresdner deposits and the other non-resident deposits, with a maturity of over one year, were not included under 'short-term drains' under the SDDS template. They are after all immediately callable. Under the debt management guidelines the maturity of a callable debt should be determined by the callable/exercise date and not by their final maturity date. These deposits - which is a very substantial part of Turkey's reserves - are immediately callable (at a penalty). Therefore, the potential liquidity of Turkey's reserves was less than what the authorities reported to the public, and it is also less than what the staff has reported to the Board.

As I understand, under our current rules, callable medium-term loans granted to the central bank do not have to be included under 'short-term drains' in the SDDS template. Following the experience with Turkey, we now have, I believe, a need to revisit the SDDS template itself with a view toward excluding from gross international reserve not only the encumbered reserves but also the deposits that are effectively callable. After all, the SDDS was set up post-Mexico 1995 to prevent surprising both the public and the Board about reserve levels. All of the above needs to be reflected in the staff guidance notes published on PDR's internal website, as these notes are currently not specific enough. Let me add that I much appreciated the staff's helpful, three-page memo in response to my earlier questions on reserves.

Private sector involvement

In my view, private sector involvement is a necessary precondition for the restoration of financial stability in Turkey. This is not only in the interest of Turkey, but is also important to minimize losses for the community of foreign private creditors. I feel that in this respect the Fund should play a facilitating role, as Turkey and its private creditors bear the prime responsibility for effective private sector involvement. In any event, having separate meetings between Turkey and groups of its creditor banks is not conducive to resolving creditor coordination problems in times of financial stress.

Challenges ahead

The delay in dealing forcefully with the banking system before the crisis means that the reform challenge will be even tougher now. The Turkish authorities will have to accelerate the pace of reforms and privatization under more problematic conditions, i.e., the greater likelihood of a slowing economy, a more difficult social and political environment, and a weaker external environment. The Fund’s increased assistance to Turkey buys some

time and opens a narrow window of opportunity to restore confidence, during which key reforms must be undertaken urgently.

Mr. Mirakhor submitted the following statement:

The authorities, management, and staff deserve to be commended for their swift response to the crisis and for exemplary teamwork. We enthusiastically supported this program because we thought that it represented the best chance for Turkey to make a clean break from its past and put its economy on a more stable footing. The fact that two reviews were completed praising "the Turkish authorities' steadfast implementation of program policies, .." suggests that the faith that this Board had in the authorities' ability to implement a tough program was not misplaced. However, a constellation of factors coalesced to create what Mr. Kiekens and Mr. Cakir call a "rapidly snowballing liquidity crisis." With the benefit of hindsight, it is easy to apportion blame, but the fact remains that the magnitude of the crisis cannot be explained fully by any one single factor. While the setback to Turkey's disinflation program is unfortunate, we continue to believe that this innovative exchange rate-based stabilization program will succeed, provided that, in addition to the full commitment of the authorities to program implementation as reaffirmed in Mr. Kiekens and Mr. Cakir's helpful statement, Turkey's major trading partners and allies do not shirk from supporting fully the efforts of the authorities.

The Turkish authorities first order of business should be to restore the program's credibility by forcefully addressing those vulnerabilities that lay at the root of the recent crisis. Towards this end, they have taken a number of critical steps in the fiscal, monetary, and structural areas. The path of fiscal consolidation is now much stronger and should help contribute to the desired deceleration of domestic demand and rein in the external deficit. Monetary policy is to be tightened so as to reduce the excess NDA created at the time of the crisis, recoup lost reserves, and achieve a durable decline in inflation. We note the new initiatives to be taken to restore confidence in the banking sector and the authorities' strengthened privatization program.

While these measures, if fully implemented, appear to be adequate for addressing the problems that emerged in recent months, the risks ahead still remain significant. Despite good progress since the start of the program, the overshooting of inflation is a matter of concern. The underestimation of the strength of inflation inertia in the system was made worse by strong domestic demand, backward-looking wage indexation in the unionized sector, and the rise in international energy prices. Given the critical importance of not allowing further slippage in meeting the inflation target, the envisaged tight stance of macroeconomic policies will need to be buttressed with a much stronger incomes policy, especially in the case of the public sector where excessive wage claims have been problematic. In this context, we support the

government's commitment to a more active role in wage settlements with the social partners and their direct approach to dealing with trade unions and employers' associations.

While the exchange rate should continue to serve as the monetary anchor of the program in the immediate term, we concur with the gradual move to a widening of the exchange rate band, concomitant with a shift to an inflation-targeting framework. It will be important that the new central bank law is enacted on time, that it provides a clear exposition of the modalities of the new framework, and that the framework is well understood by market participants. On external competitiveness generally, although ULC data are reassuring and productivity gains likely to be sustained as structural reforms are implemented, the recent deceleration in export volume growth amid a less than clear-cut picture of market share developments suggests that the authorities should remain alert to any emerging signs of competitiveness difficulties.

The deficiencies of Turkey's banking system and its vulnerability to any weakening of the macroeconomic environment were well known. It is regrettable due cognizance was not taken of the urgency for the banking system to face up to the "reality of both heightened supervision and heightened risk." We support the government's new multi-pronged strategy to deal with the banking system and agree with staff's call for a step-up in the resolution of intervened banks. The recent steps to strengthen bank supervision, and to enforce regulations on internal risk management and connected lending, are overdue and should be pursued with vigor. Moving speedily with the authorities' revamped privatization program will do much to repair the damage done to the credibility of the structural aspects of the program.

In sum, while the program faces a number of downside risks, the authorities should take advantage of the momentum that has already been built up, and the generally positive market response, to press ahead with its full and complete implementation. Given the marked widening of the current account, the vulnerabilities on the capital account, the need to rebuild its reserves, and the strength of the program, we support the proposed access to the SRF, its front-loading and continued support under the SBA.

Mr. Djojosubroto submitted the following statement:

At the outset, we would like to compliment the staff for their efforts in working under severe time constraints for intensive negotiations with the Turkey authorities based on their request of the Supplemental Reserve Facility. This agreement has been done in the face of the current turmoil in the financial market, stemming from the loss of confidence in the banking sector. The authorities' quick policy response with the support from the Fund in

tackling the current economic crisis should be commendable, resulting a calmer condition in the domestic market. Efforts to restore confidence need to be strengthen further as the restoration of market confidence is a critical factor in strengthening the macroeconomic stabilization as well as supporting the process for sustained economic recovery.

We broadly share the staff's assessment of the Turkey economy, we and fully support the proposed decision. However, we would like to raise some points for emphasis.

As elaborated in the staff paper, Turkey had partially made good progress in steering the economy before the emergence of crisis. Under the Fund program, the authorities have met all quantitative performance criteria for end-June and end-September 2000 which brought some positive impact on the economy. Following the deep recession in 1998-1999, economic activities surged markedly with consumer spending, and investment and exports played their significant role. Furthermore, the drop in interest rates in the first half of this year significantly contributed this development. However, the latter has contributed to the excessive pace of domestic demand, bringing about the current account deficit to 5 percent of GNP, a much higher compared to 1 percent in 1999. Inflation, despite showing a declining trend, was still higher than the program target. As alarming developments in the economic and financial sectors are still seen, we urge the authorities to take a close look and pursue more prudent economic and financial policies in order to diffuse the current economic crisis expeditiously.

On the macro side, as the signal of over-heating of the economy remains, we find the staff policy recommendation to be well-balanced and reasonable. Needless to say, it is imperative for the authorities to maintain a prudent and restrictive policy stance both on the monetary and fiscal fronts. We welcome the government's determination to improve the primary surplus from 3 to 5 percentage points of GNP, well above the 3 ¾ percent of GNP target set out before. This tighter fiscal stance is indeed warranted to help lessen the burden of the monetary policy that has been tight already. In this context, we encourage the authorities to keep a consistent policy to meet the performance criteria that forces any revenue above the program's baseline to be saved, not to be transformed to additional expenditures. At this stage, meeting this performance criteria is critical to curb domestic demand, and to bring positive impacts on the restoration of market confidence. However, we are concerned about the downside risks that may occur around the fiscal stance for 2001, associated mainly with the current policy practices that allows an additional increase in the civil servants' wages if the actual inflation rate is higher than the targeted inflation. As this policy will fuel future inflation and thus affect the coming fiscal stance, we would like to know staff's assessment on this issue.

On the monetary side, we fully support the tight monetary stance, which appears to be inevitable in the short-run to reduce inflation rate that remained higher than forecasted in the program. However, like the staff, we would like to remind that downside risks also exist, particularly under the current program under which the banking sector is on the restructuring process. We believe that tight monetary stance is warranted, at least for the short-run to maintain macroeconomic stability. However, with the planned implementation of structural measures, including in the banking restructuring, there is a danger that current interest rates may remain too high for too long and unless the problem subsides, there would be a further weakening of the financial position of the enterprises and banks. Lower interest rates are needed to support the restructuring of the banking and corporate sectors. The time of a gradual reduction in interest rates will be crucial. In this context, once again, we see the need of a discipline in fiscal policy in achieving the fiscal targets set for 2001 and 2002 so as to help reduce the pressures on interest rates.

The authorities' intention to adopt the inflation target, in our view, seems in the right direction. It is encouraging to note that the authorities are making the preparation in this area with the enactment of a new central bank law scheduled in April 2001. We believe that the adoption of inflation target will bring positive impacts on the creation of inflationary expectation and replace the current pre-announced exchange rate that so far did not provide strong effect on inflation expectation. Under the existing wage policy, we believe that this approach will be more useful in bringing inflation down. Of course, this will materialize if accompanied by a disciplined macroeconomic policy.

Looking at the root cause of the current crisis, financial sector restructuring may well be the key to restoring confidence. The staff note that the condition of the banking sector remain fragile as many banks are currently operating at negative interest margins. We believe that speeding up the resolution of the banks taken by the SDIF is indeed an important step, mainly to restore the currently low confidence over the banking sector. However, we see that a strategy and timing for privatization of those banks should be carefully thought, with room for flexibility, in order to avoid fire-sale under the current unfavorable market conditions and also to get at optimal benefit to the government and the economy. We also encourage the BRSA to strengthen its supervision and the regulations on internal risk management and connected lending in particular. Meanwhile, as the banking sector is heavily exposed to liquidity risk stemming from maturity mismatches, with short-term funding financing, the BRSA should also focus its attention on this issue.

On the program reviews, we can go along with the staff's view that performance under the program will be monitored through monthly reviews during the first quarter of 2001 given the still fragile financial environment. A

move to quarterly reviews thereafter, could only be considered if favorable developments occur.

In conclusion, based on the current economic developments and the authorities' strong commitment of the program, we can support the completion of the third and fourth program reviews and for access to Fund resources under the SRF. We believe that the availability of the SRF is of utmost importance so as to strengthen international investor's confidence. We hope that the authorities are committed to the program and the economy of Turkey will move forward smoothly. We wish them every success in facing their challenges.

Mr. Yoshimura and Mr. Toyama submitted the following statement:

Introduction

First, we would like to extend our appreciation to management and staff for their swift response to the emergence of the November crisis. Their intensive work in crafting this program that included measures to cope with the banking sector problems and involved two missions, should be appreciated. We also thank management for its timely consulting with the Board throughout the process, which is appropriate in this emergency situation.

In the difficult circumstances following the earthquake, Turkey has made remarkable progress through drastic macroeconomic and structural policies under the current SBA program, including a substantial decline in inflation rates, although they are likely to fall short of the target. The fact that the country has fallen into this critical situation triggered by problems in the banking sector, is proof of the difficulty for a country to do away with expected inflation once it has taken root. Being highly motivated for reforms needed for EU accession, however, Turkey is one of the countries that are perceived to have good potential. We strongly hope that the authorities and the nation will be reunited under the new program and resolve this crisis.

Nature of the Crisis

However, we were disappointed to see that staff's analysis into the nature and background of this crisis did not reflect the lessons learned from the previous crises. We thought the Asian crisis had taught us that a traditional policy response centered on fiscal tightening would not be an appropriate prescription to a crisis triggered by large capital movement. I cannot agree with staff's thinking that the crisis was driven by the authorities' delay in fiscal tightening and structural reforms, as such thinking clouds the essential nature of the problem and is likely to be perceived as staff avoiding its responsibilities.

Could the crisis have been prevented if the authorities had exercised fiscal tightening, following staff's recommendation, against the expansion of the current account deficit observed in July? Is it realistic to consider that a tightening of the fiscal position would timely fine-tune the current account, given the fact that implementation of fiscal policy requires time? Rather, can the true cause of the crisis be found in the fact that banks looked to external sources to meet the demand for the credit that expanded from the recognition that the real interest rate may have turned negative due to stubborn inflation while nominal interest rates had fallen more than the program had envisaged? Shouldn't we conclude that the current account saw a rapidly expanded deficit as a result of this? While staff does not seem to have room to analyze the short-term capital movement and the staff paper only carries yearly figures on the balance of payments, we suspect that monthly figures of the capital movement would explicitly illustrate whether the volatility in the various indicators were driven by capital movement.

If we had looked at the issue with a focus on capital movement, shouldn't the emergency measures we might have considered in July have been not fiscal tightening, but monetary tightening? If staff had not advised the authorities to raise interest rates because of satisfaction with the NDA performance being kept within the corridor, or fear of the impact on the fiscal situation, might it not imply that staff had not accurately grasped the nature of, or lacked sufficient sense of, the possibility of a crisis? Paragraph 36 describes that the CBT will take the option, if necessary, of tightening, with NDA held below the baseline. Is this measure devised in response to the lesson learned from the recent experience? We would like to hear staff's comments on these points.

Regarding macroeconomic policy management from now on, we have some serious concerns over staff sticking to the traditional framework centered on fiscal tightening. Such a policy could kill the impetus for growth. This chair would like to emphasize that the fiscal policy should be flexible as described in paragraph 47, and particularly if the interest rate is kept high, the fiscal policy should mitigate the slowdown of growth by taking an accommodative stance.

Currency Regime

It is a country that makes the final decision on its own currency regime, which the Fund should respect as long as it is sustained by consistent policies. Given the Turkish authorities' strong desire to stick to the crawling peg, we have no choice but to discuss the new program under the assumption of maintaining the current regime. However, we should share the understanding with the authorities that we have to be open to a change in the currency regime when the present policies cannot be sustained.

The crawling peg is a delicate regime. Compared with the simple currency board, the crawling peg provides the foreseeability for a change in the currency regime, as it incorporates gradual transition to a flexible regime. This regime, however, requires macroeconomic policies consistent with the predetermined level/band of the exchange rate in each phase of transition until the full float as well as structural policies sufficient for the market to believe transition to the next phase would be smooth. This current crisis has exposed the vulnerability of the crawling peg. This chair respects the authorities' policy to maintain the current regime. However, we have learned from this experience the lesson that any deviation from the program target, in particular on inflation, should be more stringently pulled back than in the past.

Banking Sector Reform

The banking crisis in Turkey has unwittingly but eloquently illustrated the difficulty in implementing banking reforms. It is most ironic that such essential measures as strengthening banking supervision and resolution of unsound banks contributed to the halt of the normal function of the interbank market, against which the authorities had to resort to a guarantee of bank obligations, a method associated with strong moral hazard. There is no doubt that strengthening the banking sector is important if the crawling peg is to have more flexibility in the future. However, the Turkish people, and even the financial institutions, were not ready to fully accept the implications of strengthening the banking sector. This episode taught the Fund a valuable lesson on the conditions for banking sector reform. We should carefully review what caused this crisis despite awareness of the problems in the banking sector at the time the current SBA program was formulated and in what ways this crisis could have been prevented in terms of the modality and sequencing of the banking sector reform.

In conducting such a review, staff is encouraged to consider the following points:

First, while staff points out the delay in banking sector reforms, the fact is that the performance criteria in this area have been fully met. Doesn't this imply that the initial program was lacking something?

Second, it has been pointed out that one of the major causes of the crisis is that a number of Turkish commercial banks have sought profits generated from the interest rate spreads between obligations denominated in foreign currencies and assets denominated in the Turkish lira, in expectation that the lira will be gradually depreciated. As a result, the net foreign exchange open position of Turkish banks stands at a very high level, where it is said that if the lira depreciates faster than expected, the foreign exchange obligation measured in the lira may expand sharply and force substantial losses to banks. We think staff should answer whether it could foresee this

situation while formulating the program, and if not, whether it noted this risk in the course of the program, and if noted, what advice staff gave the authorities.

On the other hand, it seems that Turkey is now equipped with the necessary means for fundamental reforms of the banking sector in that people are informed of what the reform of that sector means. The authorities are expected to believe that a good opportunity for further reforms has arrived.

The announcement of the guarantee of bank obligations was, however, a necessary measure to prevent a depositor run or fund withdrawal by creditors. The need for calm among bank creditors and depositors at the time of crisis is the lesson the Fund learned from the bitter experience in Indonesia. However, this is an extraordinary measure. In order to achieve the short-term value of stability in the financial market, the long term value of restoring the functioning of the market based on market principles is temporarily set aside. Since the latter value is one of the preconditions for the currency regime to move to a more flexible phase, what is paramount now is to resolve the unsound banks expeditiously and pave the way for a situation where banks see little difficulty in raising funds without a government guarantee. It is important to work out how to recapitalize and sell the banks taken over by the SDIF.

Private Sector Initiative

It was comforting to hear that the creditor banks' response was positive both in Frankfurt on December 11 and in New York in December 13. The keys to the success of the program are whether outflow of funds can be prevented as well as whether the banking sector can be properly reformed. While it is the authorities' responsibility to implement reform programs so as not to betray the expectations of the creditor banks, these banks themselves are expected to behave prudently, since any panicky actions would only result in devastating results to them, at least in entirety. When such expectation can no longer be maintained, the Fund should consider the next step.

Conclusion

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

Mr. Zoccali and Mr. Le Fort submitted the following statement:

Introduction

Turkey is a remarkable representation of the problems faced by small economies open to international trade and capital movements during a process

of disinflation. First the strong capital inflows contributed to rapid domestic demand expansion and real appreciation. Without accompanying structural reforms these conditions bred macroeconomic vulnerabilities. The change in market sentiment and the policy inconsistencies unmasked these vulnerabilities forcing either a prompt policy correction or the prospect of the failure of the stabilization process.

We commend the staff and the authorities for their prompt reaction to address the problems and safeguard the stabilization process. Staff has provided a very complete representation of the conditions faced by the Turkish economy and together with generally adequate answer to the policy dilemmas confronted. The Turkish authorities should also be commended by their integral response presented and their strong commitment to macroeconomic stability, as reflected in the agreed policy undertakings.

We believe that, in general, the authorities' program adequately addresses the challenges ahead, and should contribute to boosting confidence and strengthening banking system solvency. We consider, however, that some flexibility should be maintained to adjust policies to the extent that conditions evolve in a different fashion from those assumed under the program. Even if the program policy undertakings are fully implemented and very significant risks still remain.

Macroeconomic Vulnerabilities

We agree with staff that the liquidity problem faced by some financial institutions would have been of lesser consequence in the absence of the very serious macroeconomic vulnerabilities that developed over the last year or so, during which the increased availability of external financing and the sharp reduction in interest rates favored a rapid expansion of private consumption and investment.

The decline in nominal interest rates implied negative real interest rates, particularly considering the rigidity of expected inflation. It is worth noting that this significant softening of monetary conditions, that lead to a large increase in private demand, took place despite the NDA target being met. Expectations were reversed as the external situation deteriorated and bank weaknesses became evident.

Quasi currency board rules may have limited capacity to meet the liquidity crisis, but were not the cause of the problem or of the excessive expansion of domestic demand since the NDA deteriorated late in the game and only after the need for liquidity support for the banking system became evident

Fiscal policy also acted pro cyclically as the government spent part of the windfall in fiscal revenue associated with domestic demand growth above potential. A limit on public spending would have helped, but is unlikely to have solved the problem as fiscal policy was not the origin of the excess demand for goods and services. In this regard, it is worth noting that the current account deficit increased by more than 4.5 percentage points of GDP in one year, while the fiscal sector saving-investment gap was reduced by more than 6.5 percentage points of GDP.

What is significant is that the vulnerabilities of the Turkish economy grew with all the program targets having been met. At the same time, inflation was 13 percentage points above the program objective and the current account deficit expanded rapidly approaching unsustainable levels. Some comment from the staff at this respect would be welcome given the corrections proposed in the program.

The banking system

A weak banking system proves once again to be a most significant liability and an impediment for the success of a stabilization program under any exchange rate regime. We understand that credit risk can be limited through adequate banking supervision and welcome the efforts being made in this regard. In the context of international financial integration and free capital movements, the market risk faced by banks can also become significant in the form of foreign currency exposure through asset-liability mismatches and derivative positions, and domestic interest rate exposure, to the extent that there are mismatches with regards to the duration and maturity of bank positions.

We welcome the progress being made to close insolvent institutions and limit the market and credit risks of solvent banks. However, it is important to be in a position to determine whether the stability of the banking system is more sensitive to exchange rate or interest rate risk and how long it could take to move the banking system into a safer zone, particularly regarding market risk exposure. It is also important to note that the banks carry secondary risk from their clients, the exposure of private corporations and bank borrowers in general to foreign exchange risk can be significant.

It is understandable that the Turkish authorities wanted to stop a run on banks, but a generalized guarantee on banks liabilities, except for stock shares and subordinated debt, can prove to be extremely costly. First because in a context of high interest rates it could become attractive to take positions in riskier banks, favoring moral hazard behavior on the part of investors. Explicit guarantees on bank deposits with clear rules limiting excessive exposure to risk and moral hazard seems to be both more preferable and credible.

The exchange rate flexibility under the program appears to be initially very limited, with a band width that attains only +/- 3.75 % by end 2001. The flexibility could prove insufficient if the expectation of depreciation mounts, forcing the interest rates up. Tighter monetary conditions could even imply an over performance with regard to the inflation target, while a more rapid than programmed fall of inflation could be costly in terms of employment and activity, leading to the deterioration of the fiscal balance, as projected revenue fails to materialize. A loosening of the fiscal targets to compensate for a shortfall in revenue would not be sufficient to compensate for the monetary shock and could raise concerns over intertemporal fiscal solvency and adequacy of available financing in the absence of a credible medium-term fiscal framework.

We welcome the abandonment of the practice of wage adjustments based on past inflation and would urge development of forward-looking wage setting mechanisms, possibly based on the inflation target corrected for excesses of actual over programmed inflation. Similarly, the privatization of public enterprises is critical to enhance productivity growth, mobilize investment and, in that context, help generate more flexible labor market conditions.

We concur in the importance of avoiding that additional intervention in the foreign exchange market further deteriorate the official net foreign reserve position. At the same time, we do not see a pressing need for additional NIR accumulation, particularly considering the projected evolution of the exchange regime, and the cost at which reserve accumulation could take place. Moreover, the sterilization of additional reserve purchases could crowd out the private sector with public domestic debt. To the extent that additional reserves come from privatizations and are sterilized by the public sector, reserve accumulation should not be seen as a problem. Staff clarifications on this point would be appreciated.

The Risks Ahead

The staff considers several risks to the program, one of them, the reduction or stagnation of output in the coming quarters seems to be particularly serious. A sharp increase in real interest rates has already taken place, which together with the correction of the fiscal expenditure overruns would likely imply a contraction in domestic demand that could have important consequences in output. From this angle, the projected 3.5% real GDP growth for next year could prove to be optimistic, particularly when private investment in 2001 and subsequently is projected to grow faster than GDP, notwithstanding the sharp increases in real interest rates.

The Program

Exchange-rate based stabilization confers major responsibility to fiscal policy for the control of aggregate demand and equally important weight to supply side structural reforms to enhance competitiveness and the supply-side response. We have seen in the case of Turkey how the context of a rapidly expanding domestic demand the relative price of non-tradable goods and services has increased and inflation exceeded the parity rate given by international inflation and the expected rate of devaluation. In addition, the supply side measures were lacking. This combination has exacerbated the risks for the sustainability of the exchange regime. The excessive increase of the current account deficit is particularly relevant for a country like Turkey. Its intermediate peg arrangement, which by definition is transitory, carries with it the probability of regime change that is recognized by the authorities which in turn affects market expectations. A situation in which the expected depreciation increases due to a higher probability of modification of the exchange regime may arise, resulting in upward pressure on the domestic interest rate and reducing growth prospects.

Flexibility in redefining some of the program parameters is thus needed, in our view, to deal with these risks. In particular, if the cooling down of the economy exceeds program projections, a looser monetary policy stance would be needed. Under some conditions it might even be advisable to advance the widening of the exchange rate band to afford flexibility to accommodate some loosening of monetary conditions.

In order to relax monetary policy, either confidence in the existing arrangement is reinforced, or the system is modified by introducing flexibility to the exchange rate, thus facilitating a more intensive use of monetary policy. The authorities have committed themselves to the orderly and gradual modification of the exchange regime as confidence is regained. However, taking this road implies a consistent move to develop an inflation targeting framework as alternative nominal anchor, giving the central bank the necessary independence to make the new arrangement credible. Developing the institutions for central bank independence under inflation targeting is seen as a pre-condition for a successful flexible exchange rate regime. The banking system and the rest of the economy should also adapt to work with a flexible and thus more volatile exchange rate, in particular limiting the exposure to foreign exchange risk, and we welcome the program references to this effect.

Conclusions

In our view, the proposed program supported by SBA and SRF resources provides deals comprehensively with the problems faced by the Turkish economy, and should be effective in boosting confidence and advancing in macroeconomic stabilization and structural reform. Very

significant risks remain during the implementation phase which require discipline, flexibility and a quick response. We support the proposed decision and commend the Turkish authorities for their commitment to macroeconomic stability and wish them success in their endeavors.

Mr. Cippà submitted the following statement:

At the time of the request of Turkey's current Stand-By Arrangement, the staff paper noted that its success "would provide a clear example that crisis prevention is the best approach to crisis management". Unfortunately, this hope has not come true. While the underlying reasons for the failure of the program can be quite clearly identified, the extent and timing of the crisis appears to be more obscure. In any event, financial panic probably played a significant role, so one can make a reasonably clear case that this is a situation in which emergency financing from the Fund can make a difference. The Fund reacted swiftly and the announced arrangement succeeded – at least for the time being – to restoring market confidence. We are thus ready to support the reviews under the SBA and the request for resources under the SRF.

Before commenting on the program in detail, let me make two general remarks. First of all, I am fully aware that today's freedom of decision-making is extremely limited for the Board, given that the announcement of the agreement between government and management is widely – and rightly – seen as definitive. My authorities would, nevertheless, like to indicate their uneasiness with this situation. While there certainly is a trade-off between Board involvement and speed of decision-making, not all means may have been exploited in formally involving the Board at an earlier stage of program discussions. My second point regards the strategy of surprising the markets with higher than anticipated financing packages, as applied for both Turkey as well as Argentina. Market expectations adapt quickly and, sooner or later, expectations are bound to have to be disappointed.

Disinflation and Fiscal Adjustment

Let me now turn to the reasons for the Turkish crisis and the new program. It would certainly be wrong to say that the crisis came as a complete surprise. The risk that inflation remains higher than targeted and the vulnerability of the banking sector were identified as major risks at the outset of the program. As regards disinflation, there is ample empirical evidence that exchange rate-based stabilization programs are less effective when dealing with chronic inflation. To achieve the necessary break in inflation expectations in such a situation, it is all the more important that the disinflation effort is beyond any doubt. In view of the fact that deep-rooted fiscal problems are the underlying cause of inflation in Turkey, we should remember that a lack in ambitions to undertake fundamental fiscal adjustments is no new diagnosis for the ailments of our patient. Fiscal

adjustment continues to rely too heavily on temporary revenue measures and does not tackle problems on the expenditure side vigorously enough. The improvements of the fiscal accounts during 2000 with respect to 1999 have to be seen in the context of the marked deterioration in 1999, and announcements on how the fiscal targets set for 2001 and 2002 will be reached are vague. Moreover, there were signs of frailty in the commitment to fiscal discipline. One example is the salary increase above excess inflation granted to civil servants in June violating the program commitments. Another example is the failure to save, as committed, revenues from the unexpected over-performance. The fact that a lack of agreement on the amount of fiscal adjustment in 2001 prevented the September mission from concluding the discussion for the third review is equally revealing. All in all, it will be immensely difficult to break inflation expectations as long as the impression of a half-hearted commitment to long-run fiscal sustainability persists.

We were surprised to find no allusions in the Staff Report to the Fiscal Transparency Report (SM/00/139) issued in June, since it paints a rather bleak picture of budgeting practices. Apparently, there exist a number of public institutions whose expenditures are outside budget coverage. The main example given are expenditures of social security institutions. These services are increasingly organized in public foundations and thus not "subject to regular accounting and reporting requirements"; in 1999 this amounted to 8.5% of GNP. We would kindly ask Staff to confirm that the off-budget items pose no immanent fiscal threat and that the program has the authority to sufficiently monitor these fiscal activities.

Banking System

The weak fiscal position of the public sector is all the more cause of worries as the implications of contingent liabilities towards the banking sector remain unclear. We thank staff for the analysis in the appendix of the paper and especially welcome the inclusion of the liabilities towards the four state banks in the public debt and deficit statistics. Regarding the fiscal position, we hope that the staff is right in suggesting that taking over the liabilities towards the banking sector is fiscally digestible. Nevertheless, we would like to utter the following concerns.

First of all, how reliable are these data are? If the Turkish banking system is well capitalized and profitable (with the exception of the SDIF banks), it remains a puzzle where the "general lack of market confidence in the system" is coming from. In this respect and since most of the data are as of end-September 2000, we wonder whether estimates about the recent capital losses imposed on banks were included. Second, we are particularly worried about the risk that government liabilities towards the banking sector will increase in the near future. On the one hand, lower interest rates set off a substantial domestic credit boom (figure 6, p. 13) which may well leave banks

with a rising share of bad loans. On the other hand, like Mr. Faini, Mr. Collins and Mr. Wijnholds, we are deeply worried about the government's explicit commitment to guarantee all liabilities of Turkish banks "until the banking system is sound". In particular, the long term costs of this operation in terms of moral hazard is potentially high. Additionally, such a quasi open-ended guarantee will increase incentives towards excessive risk taking, while supervision and regulation are just starting to catch-up with common standards. The reported growth in off-balance sheet derivative positions during 2000 is certainly worrying. Overall, it is questionable if a banking system that is sheltered from market discipline will ever become sound.

PSI

We note with quite some relief that the two meetings with private banks in Frankfurt and New York have resulted in substantial roll over rates. However, in order to fully assess the success of this operation, we would need to know more about the conditions offered to the banks. We also have to be aware that the number of banks involved as well as their individual expose was relatively limited. Additionally, the challenge to involve the private sector was certainly smaller than in other cases given that the number of banks and their individual exposure was relatively modest. Finally, the government guarantee of bank deposits may also have played an important part in the successful rollover.

To conclude, let me offer some comment on the monetary policy exit strategy. We welcome the intention to gradually loosen the exchange-rate peg starting next summer. This is likely to mitigate the risk of a further appreciation of the real exchange rate. We wonder, however, whether the inflation-targeting framework will be ready to replace the peg as a nominal anchor as early as July of next year. Inflation is still substantially above its targeted mark and inflation expectations in Turkey have proved to be sticky. Therefore, forecast errors are likely to be large, making it difficult for the central bank to gain credibility. Clearly, inflation targeting is more effective if phased in only after successful disinflation. Additionally, inflation targeting requires certain institutional pre-requisites that take time to develop. A successful inflation targeting, requires these institutions to support independence of the central bank, soundness of the financial system, and soundness of public finances. We welcome, in this respect, the scheduled enactment of a new central bank law by end-April and the efforts undertaken in to strengthening the regulatory and supervisory framework for banking. The latter should particularly take into account that the exchange rate flexibility required by inflation targeting poses additional risks to a banking sector with large foreign exchange exposure. As regards the fiscal position, I can only reiterate our above remarks. And lastly, we share Mr. Faini’s concern that increased exchange rate flexibility will impose a risk to the high share of foreign currency denominated public debt.

Mr. Wijnholds thanked the staff and management for their able handling of the crisis. Regarding the exchange rate regime, he agreed with Mr. Faini's concerns. Furthermore, his authorities concurred with Mr. Cippà's concerns about the degree of Board involvement in the accelerated decision making with regard to the program. He also agreed with Mr. Cippà about whether the strategy of attempting to surprise the markets with larger financing packages, as in the case of Turkey and Argentina, was appropriate.

The Chairman agreed that, once the crisis in Turkey subsides, there should be a broader discussion about the appropriate pace and scope of decision making in the Fund in the context of crises. Clearly, consultation with the Board and national capitals is necessary. However, there was an inevitable tension, during a crisis, between the speed of Fund decision making and the degree and extent of consultations. A comprehensive discussion in 2001 could address such matters.

The circulation of the letter of intent had been delayed because it had become necessary to review the issue of the banking restructuring strategy with the authorities, the Chairman remarked.

The Director of the European I Department made the following statement:

> As background to answering Directors, let me first recall a few of the solvent developments. As the Board knows, the key objective of this program have been disinflation and achieving a sustainable fiscal position. The balance of payments was not the focus of the program; it was a side constraint on the program. In fact, however, the key development of the past year has been the weakening in the external position. This was partly due to domestic demand factors. Specifically, the decline in interest rates was much sharper, and the decline in inflation slower, than expected. This made for wealth effects that had the basis for the surge in demand which had not been allowed for in the program. Beyond this element, however, the external position was also hit by three external shocks: the price of oil, which worsened the current account by 1 3/4 percent of GNP; the depreciation of the euro which, given the exchange rate basket, hit Turkey quite hard; and the rise in international interest rates. Against this background, the staff urged the authorities from about mid-year to respond to the external developments. They did not act on those warnings through the summer despite undertakings with the Board.
>
> A second key aspect of the program from the outset was a deliberate effort to restructure the banking system. Directors will recall that five banks were closed as prior actions, specifically to establish a firmer basis for the program. While the prior actions were met, there were some delays thereafter especially regarding following through on other banking sector actions that the authorities had committed to.
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> Now, it was unlikely that any of this would have led to a crisis. Certainly, the staff was not expecting a crisis at the time it hit on

November 22. To me, a critical ingredient of the crisis was the failure of the authorities to follow through on their monetary commitments. It is very clear in the data that the situation deteriorated seriously the same day the authorities broke the NDA ceiling. Indeed, it is striking how that comes through in the data. Essentially, monetary policy gave in to some rather localized problems in the banking system, and there was a loss of control, which in turn led to suspicions about the currency that were not present up to that point.

Now, how has the program changed in the light of all this? There are two basic elements. One is restoring confidence in the currency, and the other one is restoring confidence in , and increasing the robustness of, the banking system. With respect to restoring confidence in the currency, the basic objective is to strengthen the current account and reserves. To that effect, there is very tight fiscal policy and an adjustment of 2 percent of GNP. There is also much tighter monetary policy than there was heretofore. I think it was Mr. Zoccali who questioned this: it is partly with an eye to restoring confidence in the currency and in the authorities' own policies through an increase in reserves.

Another aspect is an emphasis on privatization, partly for structural reasons but motivated also by concerns about generating foreign exchange inflows to relieve the pressure on the domestic money market. There is also an incomes policy, focused on trying to bring inflation down more in line with that of the authorities' chosen exchange rate commitment and path. The other dimension is the confidence and robustness of the banking system. There, we have the guarantee and tightened discipline, which I am sure Mr. Ingves will talk about. Against this background, I would like to address some specific questions.

Mr. Yoshimura questions the emphasis on fiscal policy in the program. I would say that the situation we face in Turkey is somewhat different from some of the situations that we were worrying about in Asia. First, the current account deficit is a major problem—it is at 5 1/2 percent of GDP in a country where it has rarely exceeded 3 percent. Second, this is a program with an exchange rate anchor: Getting back on top of the disinflation path is esential to restoring credibility in the currency. As I mentioned earlier in connection with monetary policy, fiscal policy is central in the this regard as well, partly because domestic demand was so strong and needs to be better controlled.

One of the elements that underlies the questions of Mr. Yoshimura and Mr. Zoccali is whether the program is now too tough; are there now downside risks in the program? I would say that there are. I would agree that the risks are probably on the downside in terms of growth. However, from the point of view of the program, it is better to have risks on that side than on the other side. By the same token, I would also point to the fact that we have an explicit commitment to revisit the monetary strategy every month in the program. If

things are going off track, we can adjust as we go forward. We also have an understanding, which is mentioned in the staff report, that if fiscal revenues weaken for cyclical reasons, this will be accepted.

The foregoing covers the structure of the macroeconomic part of the program. It is essentially to follow through on the authorities' desire to keep to their exchange rate path. We are trying to make that credible through the policy instruments in the program.

Now, Mr. Zoccali asked how is it that we have a program that meets all the performance criteria and yet leads us into the current crisis? My answer to that would be twofold. First, I would view the breach of the NDA target on November 22, which was a very clear breach of the program, as a key element in what happened. Secondly, the authorities had commitments to tighten fiscal policy over the summer if current account prospects did not improve. They did not improve, and the authorities did not act until in fact September/October. Then on banking, while there was a step forward at the outset of the program, there were long wrangles over the summer about what to do with the banks that had been taken over.

A third element, of course, is that the problems with the program to my mind are largely—but not solely—due to external shocks which hit the current account path and, hence, were outside the program. So, the vulnerabilities were still there despite a program which the authorities, all in all, followed mostly to the letter.

Mr. Mirakhor remarked that he would not argue the issue of the breach of the NDA target on November 22 as being the key factor in sparking the crisis. However, he had the recollection that, during an informal Board meeting on Turkey on November 28, the Director of the European I Department had suggested that the authorities had had the assent of the staff in breaching the agreed NDA corridor. He wondered whether that had been the case, and whether there had been some agreement on the magnitude of the breach of the NDA targets. While it could be argued that perhaps the Fund should not have permitted such a breach, it was impossible to know with certainty what the outcome would have been if liquidity had not been provided to the banking sector.

Mr. Faini considered that the staff report did not sufficiently address an interesting point. Growth in 2000 had been faster than envisaged in the program, but growth had been smaller than the economic contraction in the previous year, so it had been a partial rebound. Still, despite this factor, there had been a major deterioration in the current account. The first reaction would be to say, if this is so, then there is a problem with the real exchange rate. Then staff convincingly argued that the real exchange rate was not overappreciated, but at that point a puzzle remained. Growth had not been high, the real exchange rate had not yet appreciated, and the current account had suffered a major depreciation. Such a puzzle should be addressed in order to understand what would be the future prospect of the Turkish economy.

Mr. Lehmussaari noted that it was clear that the crisis had started before the interbank market had had its problems. It appeared that there were two banks that did not get liquidity from the other counterparties in that interbank market. However, to what extent can one link the developments in macroeconomic fundamentals to the problems of the interbank market? Can one say that this situation was one in which the fundamentals went wrong, but that the banking sector would have faced major problems irrespective of the macroeconomic developments?

Mr. Yoshimura said that the staff had only answered part of his own and Mr. Zoccali's question. The staff's point concerning fiscal policy was clear, but, as to the monetary side, had the staff had conversations with the Turkish authorities since last June, when the staff had started advising them on the changing external situation? What kind of discussions had occurred, in light of the negative real interest rates, the lower than expected nominal interest rates, and the persistent inflation? Perhaps there should have been some measures suggested to address such developments.

The Director of the European I Department recognized that the staff had misgauged some elements, such as inflation and the impact on interest rates. Nobody could have expected interest rates to fall as much as they had during the first part of the program. On the breach of the NDA corridor, it was true that the authorities had requested a discussion on the corridor, and that the staff had pointed out that the agreed program did not require observation on a daily basis. Although that might be a somewhat vague statement, the staff had indicted that there were some margins for using such flexibility. However, the staff had considered having margins of no more than 5 percent of base money. In the event, the authorities had breached the limit by 30 percent of base money within one night, which then continued rapidly thereafter from the second day on—against the staff's advice, which had been to pull back and return to the currency board rules.

On Mr. Yoshimura's point on monetary policy, it was true that several Directors had raised concerns about monetary policy at the time of the Fund's approval of the program, the Director continued. However, the monetary framework was a given of the program—it was quasi-currency board rules and, linked to that, the pegged exchange rate. This meant that, in effect, monetary policy could not be used with much flexibility. It had been particularly unfortunate that there had been the expansionary effects of the currency board arrangement in the first part of the program, but when challenged by difficult circumstances, they were breached within one night. So, there had been a clear imbalance in the monetary program. In a historical perspective, clearly such an undertaking would not have been pursued without greater assurance that the monetary rule would stick when it would become challenged.

On Mr. Faini's question on the domestic factors behind the weakening of the current account, there had been an allowance for a very strong 6 1/2 percent growth in domestic demand in the program; in the event, it turned out to be 12 1/2 percent. At the time of the initial Board meeting, there had been serious concerns expressed about the large fiscal adjustment proposed by the staff, against the background of the forecast growth of 5 ½ percent. Despite that upbeat assessment of domestic demand growth, the actual outturn had far exceeded expectations, largely because of the large windfall stemming from the much

sharper fall in interest rates than inflation, contributing thereby to the sharp weakening of the trade account.

In sum, three factors—the weakening of the external position, a banking system which the staff had tried to shake up and reform but clearly had not become reformed, together with a monetary policy which failed at a crucial moment—were each critical to understanding what actually happened. Basically, it was necessary to rebuild the credibility of all three of those instruments, one being expressed in the form of confidence in the currency and the other one being expressed in terms of confidence in the banking system.

Ms. Lissakers asked the staff about the sharp increase in real bank credit to the private sector beginning in early summer 2000, which was evident from Figure 6 on page 13 of the staff report. Clearly, much of that increase was consumer credit, which fed import growth. It had been clear from the beginning of the program that the big risk was the perverse incentive for overexposure in the banking system that any fixed exchange rate regime in the context of an open capital market and open banking market presents. In light of the experience with the Turkish program, it would be important for the Fund to consider whether the right kinds of vulnerability indicators and policy options for national authorities are embedded in the Fund's monitoring systems for program and other countries. In the case of Turkey, it should have been possible to monitor on a weekly basis the level of domestic consumer credit expansion. It should also have been possible to redress that increase immediately—not through fiscal measures, which are slow to work, but through regulatory measures. Given the constraint on monetary policy, such a move should have been an option.

The other indicator that, under such conditions, should have been monitored continuously was the buildup of interbank credit, Ms. Lissakers continued. The interbank market is not supposed to be used to finance loans; rather, it is a liquidity management device for well-run banks. Clearly, whenever the Fund becomes aware of a banking system where there is any reliance in the interbank market to fund loans, it should be regarded as a red flag that should be forcefully communicated to the authorities concerned—particularly where there is a weak banking system. The Fund's program monitoring was currently conducted on a more or less quarterly basis, sometimes monthly, during which the stock situation was reviewed. However, it appeared more appropriate to ask for reports on these kinds of indicators, which can be very useful flags for trouble ahead, on a weekly basis. Such data could be collected without the need for a staff mission to the country. Given the experience in Turkey and Indonesia, and in many other countries, the Fund should seriously consider improving its own monitoring.

The Director of the European I Department replied that bank credit had been monitored on a weekly basis, but the core of the suggested policy response had been through fiscal policy rather than through the instruments mentioned by Ms. Lissakers. Although the staff might have been remiss in that regard, it was important to understand that, because of the program, the staff had been instrumental in helping to establish a new independent supervisory agency in August 2000. There had been much turmoil in terms of the institutional arrangements about the supervision of banks, and that contributed to part of the problems.

The monitoring of developments in the payments mechanism was a useful suggestion, the Director continued. The staff had been monitoring such, although it was likely that the problems alluded to by Ms. Lissakers did not surface until just before the outbreak of the crisis. The repurchase market had been functioning quite smoothly through the first half of 2000, and the banks that were increasing interest rate exposure had been essentially financing themselves—and fairly easily so—through the repurchase market.

The staff representative from the European I Department in response to questions and comments from Executive Directors, made the following statement:

> In response to Mr. Cippà's question on whether all off- balance items have been included in our fiscal accounts, I can confirm that we have very broad coverage of the fiscal accounts. He also raised the issue of temporary measures vis-à-vis permanent measures. At the moment, what is left in terms of temporary fiscal measures is about 1 percent of GNP. These measures, however, will stay in place until the end of 2002, and this will be partly offset by the fact that there are also some temporary expenditures in the budget, those related to the earthquake, which accounts for about 0.5 percent of GNP. On that basis, what is temporary and will disappear after the end of 2002 is only 0.5 percent of GNP.
>
> Mr. Faini raised the issue of incomes policy and how this relates to our assessment of the flexibility of the Turkish labor market. I continue to believe that the Turkish labor market has a large, nonunionized component that is extremely flexible. That does not mean that incomes policy is not important through imitation effects. That is why from the beginning the program included an important incomes policy component as far as public sector wages are concerned.
>
> During the year, as we realized that inflation was not coming down as expected, we introduced in the letter of intent more specific commitments in the area of incomes policy in the private sector. The reactivation of the Economic and Social Council was convened at the end of June, although this has not been as effective as hoped. The staff and the authorities now believe that a less formal way of incomes policy could be implemented. I hope that it will be possible in this way to moderate the key decisions of some key industrial group not only with respect to wages but also with respect to their prices.
>
> Mr. Collins asked whether we have made projections on a monthly basis. We can provide monthly projections for private capital inflows. We have quarterly projections that we can make available. I think those have also been based on some monthly assessment of the behavior, but for the moment what we have for sure in the program are quarterly figures, and we can provide them to you.

The Director of the Monetary and Exchange Affairs Department, in response to questions and comments by Executive Directors, made the following statement:

Banking troubles tend to unfold gradually, often culminating in dramatic systemic peaks. This was also the case in Turkey. The recent crisis turned out, in large part, to be a crisis of confidence. The ongoing bank restructuring process was overtaken by escalating events, causing a systemic crisis. Interest rates went up dramatically, so the value of security portfolios dropped. Creditors became worried and did not roll over credit to Turkish banks started to cut their credit lines, causing liquidity problems in banks that had financed long-term investments in government securities by borrowing short term. Currency outflows and extreme interest rates created a situation that could no longer be sustained. Without quick action to address the problems, the systemic banking crisis could have led to a meltdown of the financial system.

Under these circumstances, three interdependent measures are needed to deal with the problems. First, there is a need to stabilize the situation and build confidence; this is done by issuing a general guarantee. Second, there is a need for a system to intervene in troubled banks. Third, over time, banks taken over by the government need to be restructured and, in one form or another, closed or put back in the hands of the private sector.

The first action in Ankara was to try to stabilize the situation and to start the process of restoring confidence. Confidence is something that can be lost in hours while it may takes days or many months of hard work to restore. With the announcement of the government's guarantee protecting all depositors and other creditors, the situation calmed down and confidence began slowly to return.

Second, the issue was to make sure that the legal procedures and institutions in place were used to deal with insolvent and undercapitalized banks. With the passage of the new banking act, and with the setting up of an independent bank supervision and regulation agency, both the infrastructure and the legal framework gave the authorities all the powers needed to deal with the undercapitalized or the insolvent banks. Let me also note that, altogether, the organizational structure to deal with banking problems is new, but it is more developed than in many other countries; there is a clear division of labor and responsibility between the treasury, the central bank, the supervisory agency, and the deposit insurance agency.

The third issue was to make sure the authorities had a strategy on how to deal with intervened banks. Such a strategy had been developed earlier for the 11 intervened banks and the adopted strategy had also broadly been announced to the public, although there was no mention of how the end results could vary from bank to bank.

Finally, given that we are where we are, let me note that to deal with the many intervened banks at the same time is a sizable undertaking. The resolution of the banks cannot be dealt with within just a few weeks. The timetable is spelled out in the LOI, and for 8 of the 11 banks the process will be completed at the latest by end-September 2000. The timetable needs to be adhered to and, although it is not known yet how many banks will be closed, it should be noted that 8 of the banks have together 15,000 employees and 700 branches. All in all, the main building blocks to manage the process are in place. So far, the operation has worked. Long-term confidence demands that the different steps systematically run their course, and finally, equally important, what is done needs to be efficiently communicated. This is about the strategy in general. Let me move to the questions.

What does the guarantee cover? The guarantee covers on-balance and off-balance sheet risk, but it does not cover all assets generally. Why is it that the details have not been published yet? The Turkish authorities are presently working on the details; we are expecting to receive their drafts today or tomorrow. When this work has been done, they have planned to distribute this to creditors and to embassies all over the world. Normally, it takes some time to do the technical work in these things. The issue of counterparty risk and supervision activity of the BRSA, and particularly the currency aspect of the guarantee must be determined. The supervisory authorities are well aware of the issue of counterparty risk and the need to carefully look into this. This is certainly one of the issues that will come back for us in January.

On the issue of the schedule for dealing with changed rules for directed lending, the schedule is quite slow; it is probably desirable to speed it up. Whether it is feasible or not to come up with a judgment on that, we would have to look at the position on a bank-by-bank basis, so this will come back too.

On the issue whether something was missing in the initial programs or not, we have heard earlier from the Director of the European I Department that all the essential bits and pieces have been in the program for quite some time. Of course, with hindsight, it would have been better if everything had happened many years ago when it comes to dealing with the banks, but this is the way it happened. Part of these things were overtaken by events.

On the issue of foreign exchange position and the net position, looking at the numbers in the appendix, the net position has actually been fairly stable in the course of the past year; it has not really changed very much, and it is not very large. Having said that, though, what we are now dealing with the different gross parts on a bank-by-bank basis so that we feel confident that there are no discrepancies in the end that cause a lot of extra risk in the system that comes for the January review. On the issue of how reliable are the banking sector data, the numbers that we are getting appear satisfactory.

There was a question of why, if the banking sector is reasonably well capitalized, was there all of a sudden a general lack of market confidence in the system? When interest rates go to a thousand percent or more, it becomes very difficult to distinguish between good banks and not so good banks in the peak of a crisis. In that context, something needs to be done. Otherwise, if the situation continues for an extended period of time good banks will turn into bad banks relatively soon. So, this is the situation that was at hand a few weeks ago. Something needed to be done, and that is what we tried to correct.

Finally, there was a question of to what extent we have included developments in the past month or so, given the fact that the calculations we have done in the appendix are based on September numbers. The answer is that we have done so. On the last page in the report, you can see some stress-testing indications of what happens. Essentially, the result is that if interest rates remained very high for a very long period of time, we would have continued problems in the banking sector.

Mr. Yoshimura asked the staff to comment on the relationship between the crawling peg mechanism and the kind of imprudent banking behavior observed in Turkey. There was a view that the crawling peg mechanism helped foster such kind of banking behavior, including supporting their portfolios by borrowing foreign currency denominated loans.

The staff representative from the European I Department remarked that, although the official data showed that the open position of banks remained somewhat stable during the program, the imprudent practices were now clear, as banks were opening their spot position and covering it with their forward position. It was his personal view that the critical aspect was a matter of implementation of supervision and regulation. Although the regulation was satisfactory, the implementation of supervision was lacking, partly because of the problems associated with the setting up of the BRSA. This led to a difficulty in trying to reduce the growth of the possibly poor quality forward contracts—the total value of which was still not known. If they were of all good quality, then there would not be a problem; however, he had personal doubts about that. The matter would be one of the focuses of first review of the program.

Mr. Cippà, in response to the comments of the Director of the Monetary and Exchange Affairs Department, pointed out that the confidence crisis preceded the sharp rise in interest rates, so the thousand percent interest rate level was a consequence of policy reaction. However, he had questioned the quality of the data because it remained unclear why this confidence crisis occurred based on the data that showed that the banking system was basically sound.

The Director of the Monetary and Exchange Affairs Department replied that it was difficult to provide a clear picture of why such events occurred. Looking at the data, clearly it was well-known that there were weaknesses in the Turkish banking system. Exactly to what extent that was part of the overall picture at the time of the crisis was difficult to answer.

In response to a question by the Chairman on the link between the crawling peg and behavior of banks, the Director pointed out that that link would be dependent on the overall macroeconomic picture and a number of other things that were happening in the economy. The matter did not rely solely on the crawling peg, as such, but on the overall macroeconomic picture and what sort of judgments the bankers were making at that time, depending on the overall situation and whether they believed in the overall situation.

Mr. Yoshimura added that it was well-known that a crawling peg provided some degree of predictability, which was for the sake of the stability of the system. However, that stability could also inadvertently promote speculation. Clearly, the overall situation depended on the macroeconomic environment, but if that environment matched such speculative purposes, then such kind of crawling peg mechanism could give some sense of assurance to bet on one side.

The Director of the European I Department agreed that an exchange rate commitment provided an assurance with respect to the exchange rate, but the shocks to the system then showed up not in the exchange rate but in interest rates. What clearly happened in Turkey was that three banks specifically, of which one is Demir Bank, had made bets on interest rates—they were essentially betting that the authorities would succeed in their strategy. They would borrow very short, buy long paper, and they made huge amounts of money for six months on that basis. What then happened was that, for some reason, interest rates in Turkey rose from the low 30s percent to the high 30s and to the low 40s over a relatively brief period of time. That led those three banks to lose massive amounts of money.

The precise details and motivations behind what followed in Turkey were unclear, the Director continued. For instance, there were unconfirmed rumors that the larger banks had attempted to drive the smaller banks out of business. However, the actual events that followed were clear: those banks suddenly needed liquidity to finance their repurchases that they had taken before, and these banks had become riskier. The big banks had refused to finance them in the repurchase and overnight markets, and so these banks were cut off from their sources of liquidity. The whole system dried up and exploded.

The important point he would make was that the three banks who were also takers in the market, were the ones who always came at the end of the day to the central bank, were the ones making those bets on interest rates, the Director stated. Those banks had not factored the variability of interest rates consistent with the exchange rate peg arrangement. The collapse of the system began at that point, with the authorities in the end unwilling to inflict the punishment of the market on those banks.

Mr. Faini agreed with Mr. Yoshimura's point that the continuation of the exchange rate regime was providing a guarantee, to the extent that was credible to banks. There was an additional guarantee, which was a generalized guarantee to depositors and creditors. In that regard, the staff strikes the right note: What mattered at the current juncture was not only the regulations enacted, but that the regulations were being implemented. The current situation was one in which there existed scope for risk of opportunity behavior because of those two

guarantees. If a further crisis were to strike, then an abandonment of the exchange rate would be more devastating than it would have been in November 2000.

On privatization, it was still unclear what the meaning of strong management rights would entail, Mr. Faini continued. The current environment for the telecommunications markets was not very positive, as there was not demand for telecom equity in the markets. Under those conditions, the possibility that the offer for Turk Telecom might not be successful cannot be discounted. The definition of strong management rights might play a role if the Turkish government decided to retain veto power, which would not be seen by the markets as strong management rights.

The Director of the European I Department, in response to Mr. Yoshimura's question, recalled that the Turkish program was a disinflation program. An exchange rate peg had been chosen, because that was the most effective means of reducing inflation. The whole objective of the program had been to disinflate, and provide fiscal sustainability subject to a side constraint on the balance of payments, which the staff had expected to be observed. It was clear that, from the point of view of the capital account, that was not the optimal way to proceed in the current environment, but that was the context inherited in the program.

Mr. Yoshimura remarked that the program had not been so successful in eliminating the persistent inflation expectations. On the other hand, the current account had deteriorated and it had been used as a means for speculation, because of the nature of the crawling peg.

Ms. Lissakers remarked that the Turkish experience was reminiscent of the experience with the Russian Federation program. The Fund had helped set up the same sort of disinflation device in Russia, as well as in several other cases. Presumably, some lessons had been learned from such experiences, which was the point of vulnerability under that kind of regime was the behavior of banks. It had been assumed that fiscal safeguards would take care of that, but they rarely did. That was because - especially in the Turkish context - whenever there was draconian fiscal adjustment tightening, fiscal actions were slow, politically complicated, and thus difficult. Whenever a huge arbitrage opportunity for banks is set up without sufficient regulatory oversight, then the stage is set for the kind of blowup experienced in Turkey. Clearly, the question was whether the Fund has now learned the appropriate lessons. What was being done not just to resolve the existing bad banks, but to put in place safeguards, assuming that there would be once again a positive trajectory on inflation and interest rates come down, so that the cycle was not repeated in Turkey? Would anything be done differently, seeing that the same exchange rate regime was being retained and there would be the same incentives for bank behavior as there had been before, although the external market may be less amenable to providing large additional funds for a while? What conclusions could be drawn from this experience? One conclusion was that fiscal policy could not be the only weapon in the policy arsenal.

The First Deputy Managing Director expressed some puzzlement as to the tone of the current discussion. The staff had not ignored the banking sector. The staff had been encouraging the authorities to reform the banking sector from the beginning of the program - in fact, such reform was a critical part of the program. However, as with all Fund-supported

programs, there was a principal agent problem in running a program. The program was agreed with the Turkish authorities, and then they did not fully implement the provisions - starting from about June 2000, because the program was beginning to deliver positive results. At that point, the staff continuously encouraged the authorities to implement the agreed measures, including in the banking sector and the banks' open positions. For example, the staff stressed the importance of establishing a bank supervisory agency, which should have been done in May, but had not been accomplished until August 2000. There had also been continuous pressure to respond to the current account deficit, which was what raised considerable concerns in the markets about the viability of the program's overall strategy. In November, the staff mission returned with strengthened measures on the banking system.

In response to Mr. Yoshimura's comments, the First Deputy Managing Director recalled that the crawling peg was the essence of the disinflation program. The peg has helped bring fiscal solvency to Turkey under the situation of very high real interest rates in which the authorities had been operating. Indeed, the authorities - and the economy more generally - would have experience an early, major problem if real interest rates had remained very high. In the event, real rates turned negative at the start of the program, which provided a huge boost to the fiscal solvency of the country. It had been the failure to stay with the macroeconomic policies and with the banking that had led to difficulties. It was important to recognize that the actions of national authorities cannot be precisely controlled, which was where many of the difficulties arise in a program. Clearly, one lesson learned is that there must be even more insistence on the Turkish authorities with respect to the banking sector. However, it was also clear that the advice provided by the staff on essential measures was not incorrect.

Therefore, there were limitations to what could be achieved from the Fund side, the First Deputy Managing Director continued. The Turkish authorities were responsible for carrying out the agreed program; if there were slippages, the Fund could insist on meeting agreed measures and targets. There was always the difficult question of whether and when to publicize any of the Fund's concerns. The further dilemma in the context of the Turkish program was that the authorities had been fulfilling many of the program's aspects, while moving too slowly in some other areas—a dilemma reminiscent of the current situation with Argentina. The financial markets were supporting the progress of the Turkish authorities, so it became challenging to point out to the authorities that, were they to persist in their current behavior, then a crisis could ensue - a point that had been clearly made to the authorities. The authorities had responded by pointing to the significant support being received from the financial markets, and the fact that the market consensus had been for a current account deficit of about 3.5 percent of GNP, rather than the staff's revised forecast of about 5.5 percent. In the final analysis, the staff had provided the appropriate policy advice and had encouraged the authorities to implement necessary reforms. However, after a period of about 6 months during which the authorities had performed almost perfectly, they were subsequently not able to move fast enough to implement essential reforms.

Mr. Esdar said that he agreed with the comments made by the First Deputy Managing Director - particularly as they pointed to the effects of public discussion. The Fund rightly became more involved in the financial sector issues in such programs, and Ms. Lissakers

correctly made the point that at present, under different circumstances, there was a question of mismatch in maturities and the interbank market using overnight rates for long-term borrowing. However, it was important to make clear - especially with regard to the public perception of the Fund's role - that the Fund can do much encouragement with regard to structural reform, such as the establishment of a properly functioning banking supervisory system, but the Fund was not in a position to look at portfolios and the financing structure of each particular bank. The crisis in Turkey had been triggered by wrong policies by the authorities, but it was also triggered eventually by wrong management decisions in two or three banks, and the Fund was not in a position to deal with such matters. The external explanation of the Fund's role would need to clarify the extent to which the Fund could act in the financial sector.

The Chairman reiterated that the upcoming review of lessons to be learned from cases such as Turkey would include the issues referred to by Mr. Esdar.

Ms. Lissakers clarified that she had not said that the staff had ignored the banking sector; clearly, the staff and management had appropriately insisted in meeting the requirements of the program. However, as the program would retain the pegged exchange rate regime for some time, it would be appropriate for the Fund to embed some refinements or early alert indictors (such as she had mentioned earlier), because the same kinds of temptations would remain for the financial sector. Therefore, there would need to be very careful monitoring of the whole market position and interbank positions, as well as domestic credit—particularly given the assumption that interest rates would come down. Moreover, she was not questioning the staff's assertion that an adjustment to fiscal policy had been the appropriate response in the context of an overheating in the economy. In the event, the suggested additional fiscal measures had not been implemented. Rather, in the context of the circumstances, perhaps a more complex mix of safeguards was necessary. She had not asserted that the staff had failed in their mission; rather, it was important to learn the appropriate lessons, and apply those lessons going forward.

The Director of the European I Department remarked that, on the privatization issue, the core of the problem in the case of Turk Telecom is that the government was unable to sell a majority share of Turk Telecom. Apparently, a change in the constitution could be required. Therefore, it was necessary to try to make attractive a minority share in Turk Telecom, with the government retaining a two-thirds share. This had been a somewhat difficult process, but the World Bank and Fund staff were overseeing the process to make sure that in the final tender to be issued in January 2001, the strategic owner had effective management control of the corporation. Given the shares, it was a somewhat delicate balancing act, but it was important to ensure that the actual control met that test. The World Bank, in particular, which had a number of staff stationed in Turkey working on the privatization program, was working especially closely.

On Ms. Lissakers's concern, the Director confirmed that the staff would follow-up on all her suggestions. He personally considered that the banks in Turkey had become quite cautious, as the variability of the interest rates had been a wakeup call for that banking

system. It would not be surprising if the result would be a credit crunch rather than credit largesse over the next few months.

Mr. Esdar made the following statement:

Today's decision comes at a critical juncture for Turkey's future. During the first half of 2000, Turkey made some promising progress, supported by a SBA with the Fund. In its report, staff carefully delineates the external and internal causes for the recent mounting of problems under the program. The belated tightening of fiscal policy, the lack of progress with structural reforms and the delay in the resolution of the problems of the overtaken banks are all well described in the document.

Today's proposed decision is proof of faith of the shareholders and Management of the Fund in the capabilities and the commitment of the authorities to resolve the confidence crisis by taking the necessary, even though certainly not always popular, adjustment measures. We support the proposed decision. The program, if comprehensively implemented, should enhance market confidence also by bringing Turkey's foreign exchange reserves back to a more comfortable level. In this context, I would like to thank staff and Management for their hard work and never ceasing dedication during the past weeks, to bring this program to the board today.

The success of the adjusted and reinforced program will first and foremost be a reflection of program implementation. The Turkish authorities will have to truly prove their commitment to and their ownership of the program in the coming months. Staff bluntly describes the formidable risks to the program, this highlights even more the crucial importance, not only for a comprehensive implementation but also for the preparedness to react with additional measures if required by circumstances.

The program design adequately addresses the current weaknesses of the Turkish economy. I would like to comment on some of the elements.

First, on the macroeconomic framework.

The Turkish authorities have requested to maintain the exchange rate peg as a macroeconomic anchor. This puts a significant burden both on fiscal and on incomes policy. It certainly was not surprising that slippages in the fiscal area contributed to the current problems. Therefore, we would urge the authorities not to repeat these mistakes and to fully adhere to the fiscal targets of the program. The objectives under the program certainly are ambitious -- yet achievable.

The second crucial pillar to bring inflation down and to ensure external competitiveness would be a tight wage and incomes policy. In this regard, I

am not convinced that the indexation mechanism embedded in the incomes policy approach is sufficiently self-restraining. Already, under the former program, this chair had encouraged the authorities to, if at all necessary, make only very cautious use of the de facto indexation mechanism for salary adjustments provided by the ex post catch-up provisions. I would like to reiterate my concerns in this regard, as this mechanism not only conflicts with the objective of breaking inflationary expectations; it could also pose serious risks to the budget.

Let me add some remarks on the exchange rate system and its relations to monetary policy. Perhaps I misread the staff report, but I got the impression that there is an attempt to meet too many objectives at the same time. Under a peg system, monetary policy has to fully concentrate on the exchange rate objective. In so far, I was somewhat surprised to find that monetary policy will also focus on trying to recover part of the foreign exchange losses of recent months, which could be interpreted as the acceptance of currency appreciation to provide room for reserve-accumulating interventions? I am also not sure about the meaning of the first sentence on page 25, which argues that the CBT would have the option of keeping NDA tighter than envisaged if monetary developments threaten the inflation target. I have some problems to reconcile this objective with the exchange rate anchor policy. To put it into economic terms: The system seems to be over-determined.

To be sure, I agree with and endorse the exit strategy embedded within the program, and I am fully aware that when the exchange rate band widens, the exchange rate anchor function for monetary policy has to be replaced with different monetary objectives, such as inflation targeting. However, it is crucial to adhere to this sequencing and not to confuse the objectives.

Staff's comments on these issues would be appreciated.

Let me now turn to the structural side of the program. There can be no doubt that the central element is the consolidation of the banking system. Quick progress in this area is a crucial precondition to restoring market confidence and to strengthening the stability of the system in general. Transparency in this regard would help convince financial markets that efforts are going into the right direction. In this area, we see some room for improvement. It certainly is noteworthy that the crisis was also triggered by communications deficiencies.

I noted the timeframe envisaged under the program for consolidating the problem banks or, respectively, revoking their licenses. It certainly is true that these operations need time, but it is also true that such consolidation operations are always accompanied by uncertainties which conflict with the need to reestablish confidence. Therefore, we would encourage the authorities

to speed up the process as much as possible. Mr. Collins in his GRAY gave some more detailed comments which I fully endorse

Coming back to transparency, in the process of consolidating the banking sector, guarantees can – in spite of their moral hazard effects – have an important impact by restoring confidence. However, they can fulfill their confidence-building effects only if they are disclosed to the markets in a convincing and transparent manner. In this regard, I was puzzled to discover that the details of the guarantee will only be disclosed to the public by mid-January. Until then foreign banks and embassies will be informed only by individual letters. This in my view not only significantly limits the confidence-building effects of the guarantee system, it also, because of the selective information policy, gives rise to misinterpretations and questions. I would strongly urge the authorities to reconsider this decision.

There are other important structural elements in the program, such as privatization, reform of the energy market and de-monopolizing certain markets. These issues are well discussed in the paper. I endorse them.

There is one final issue. Turkey's difficulties can only be overcome if the private sector joins into the efforts. I therefore welcome the reaction of the banks in Frankfurt and New York. The commitment to maintain the interbank credit lines is an important contribution to stabilizing the situation. Eventually, however, it is up to the Turkish authorities to reestablish confidence and to attract inflows and direct investment. The program - notwithstanding some question marks - provides a good basis which deserves our support.

Mr. Palei made the following statement:

The staff describes several reasons for the recent bank run followed by the liquidity crisis and sharp depletion of international reserves in Turkey. The appreciation of the U.S. dollar and higher oil prices are mentioned in the staff report as negative exogenous developments. Some entrenched structural features of the economy, according to the staff, contributed to the inflation inertia. Finally, hostile actions by some of the banks against their competitors exacerbated by the rigidities of the monetary policy could have played a role in provoking the crisis. The more important issue, however, is still whether the authorities' policies could mitigate the vulnerability of the Turkish economy to changes in market sentiments.

Higher than expected inflation and large current account deficit resulted from a combination of a surge in domestic demand and cost-push factors. Faster than expected decline in nominal interest rates and stronger than expected inflation inertia lead to low real interest rates and strong expansionary bias in the macroeconomic policy. In April and even more so in July, directors called on the Turkish authorities to embark on additional fiscal

consolidation to dampen the expansionary effects of the real interest rates. It follows from the staff report that the Turkish authorities were hesitant to apply the agreed upon fiscal tightening, thus, contributing to the increased vulnerability of the economy. However, Mr. Zoccali and Mr. Le Fort, in their preliminary statement, question the ability of the fiscal policy alone to prevent the overheating of the Turkish economy. It certainly is an interesting question and I look forward to the staff's reaction.

The second area of weakness in program implementation, in my view, was the lack of a comprehensive incomes policy, which had to be an essential element of the exchange rate based anti inflationary program. In the countries with a long history of persistent inflation the goal of the incomes policy in exchange rate-based stabilization program is to try to weaken inflationary pressures on the costs side. In Turkey, the widespread backward-looking indexation played a major negative role in price developments during the year.

Unfortunately, during the period under the program, the incomes policy remained limited to adjustments in wages of public servants and negotiations with public workers. The authorities shied away from a proactive broader dialogue with labor and businesses. At the outset of the program the staff and the authorities realized that the labor markets in Turkey were extremely fragmented with little data available for analysis and monitoring of the developments in this crucial for any area. However, even in this difficult conditions an attempt had to be made to broaden the incomes policy. In April and, again, in July, this chair called on the authorities to focus on the work of the Social and Economic Council and insisted on additional efforts to institute a feasible set of other measures if the work of the Council proved to be inefficient. Frankly, I still do not see how the authorities plan to proceed in this area and I would appreciate it if the staff or Mr. Kiekens could shed some light here. It is now apparent that the authorities had to react more flexibly to the challenges of the stabilization and, probably, had to go beyond the initially set program targets.

At the same time, I would not go as far as some observers who question the very possibility of success of the program and who blame the peg for Turkey's difficulties. When they talk about the risks of pegged exchange rates as opposed to the virtues of flexible exchange rates, they should not forget that, at the end of last year, Turkey was on the brink of economic collapse and that the decision to embark on this program was widely accepted as an approach most likely to succeed. At the time of the adoption of the program, both the Turkish authorities and the Fund understood the risks associated with exchange rate based stabilization.

The Turkish authorities took full responsibility for this ambitious undertaking and demonstrated full ownership of the decisions taken in the course of the program implementation. Faced with recent severe pressures on

the Lira, they have decided to strengthen the program and already completed several prior actions. Overall, under the existing circumstances, the provision of large additional resources by the IMF under the SRF umbrella is quite appropriate and I endorse the proposed decisions. However, this is not an endorsement of the provision of financing exceeding market expectation. Mr. Cippa, in his Gray, referred to financing of Argentina and Turkey as related cases and saw a dangerous pattern. This matters may be discussed by the Board at a later stage.

I agree with the staff that the existing stability in Turkey is fragile. This fragility is mostly due to the doubts about the sustainability of the pre-announced crawling peg. Since the beginning of the program the real exchange rate has notably appreciated. Quite understandably, coupled with a large current account deficit it remains a source of markets nervousness. The prevailing attitude seems to be that an abrupt switch to a floating regime would be extremely risky. On balance, I agree with the choice made by the authorities and supported by the staff and Management. At the same time, I note that many directors call for a faster transition to a more flexible regime through more ambitious widening of the exchange rate band and, at the same time, through acceleration of institutional preparation for inflation targeting. The speed of the exit is, of course, a judgment call, and there is a question of whether the proposed period is sufficient to anchor inflationary expectations and support them with sufficient improvements in the structure of the Turkish economy.

The authorities have already announced their plans for additional fiscal consolidation. In accordance with this announcement, the program with the Fund now has an additional performance criterion, a quarterly ceiling on total non-interest expenditure of the central government. While endorsing this approach, I also agree with the staff that program projections are subject to uncertainty about the return of confidence and the path of interest rates. The staff warns about the possibility of higher interest rates dampening economic activity in Turkey. If such risks materialize, fiscal loosening could be called for. Hence, in the period ahead, the macroeconomic policy mix should depend on the behavior of credit markets and should not necessarily be too rigid.

Finally, I do not believe that the perceived weaknesses and reckless behavior of the banks are to blame for November crisis. The growth in arbitrage activities of the banks was, of course, expected under the program. Most of the bets by the banks seem to be hedged and pure speculation appears to be quite limited as it follows, for example, from the analysis of foreign exchange cover in the banking system. While on the subject, I welcome the intention of the staff to look closely into the counter party risks and quality of foreign exchange contracts. The behavior of the financial institutions was rational and was consistent with credibility of the program. What happened was relatively localized problem before the large injection of liquidity into the

system. The source of vulnerabilities now are high interest rates, as it was made quite clear in Appendix I. Banks do have to go through major transformation of their role and the banking reform remains one of the pillars of the program. I endorse the strengthened hands-on strategy with respect to financial sector in Turkey. I welcome the authorities' intention to make their plans transparent and well known. I support Mr. Esdar's detailed comments on transparency in the banking sector. Elimination of uncertainty associated with the authorities' policy in this core area should help the return of confidence.

Mr. Bauche made the following statement:

I would like to thank Staff and Management for their swift response to a crisis that occurred just one month ago.

It has been very clear since its inception that the Turkish program is a risky one. After a few months, the Turkish authorities have had to face a confidence crisis in relation with the banking sector, which cannot be seen as completely unexpected, given the program setbacks that occurred in the second half of the year. Now, even if the first figures on bank voluntary rollover operations are rather encouraging, the situation remains difficult and the confidence of private sector investors needs a clear boost.

We can support the continuation of the current exchange rate regime since we believe that the Turkish program has achieved significant results and that proceeding differently at this juncture could entail a serious risk to backtrack to the situation prevailing before the beginning of the program. The achievements in terms of disinflation, even limited at this stage, must be maintained, and the crawling peg, by offering a nominal anchor, can play a key role in this context.

That being said, asserting that the cost of changing the exchange rate system may be higher than keeping the existing one does not call for a complete status quo : the credibility of the current exchange system, which has undeniably suffered from the recent events, needs to be strengthened. Against this background, we believe that the Turkish authorities must absolutely stick to the commitments of the LOI since they have used all the room for maneuver they have painfully gained. In particular, the incomes policy should be appropriately kept under tight control to demonstrate the authorities' commitment to the program and reduce the renewed inflationary pressures. We also welcome the reflections initiated by the authorities on a monetary framework aimed at reinforcing the disinflation process after the progressive envisaged evolutions of the exchange rate regime.

Accelerating the restructuring of the banking sector must clearly remain on top of the authorities' agenda. This issue was clearly identified at

the beginning of the program. Let me quote some parts of the staff report issued when initiating the current program : «The banking sector is not as strong as the aggregate official statistics suggest …» ; «the problems arise from years of lax supervision standards and implementation» ; «the statistics mask the weakness of a sizable portion of the banking sector». Staff's diagnosis for today's report is even more severe, when describing how unprepared the banks were for an era of lower earnings from government debt - a dangerous game where many of them have had their fingers burnt.

At this stage, the authorities can but only take bold steps in the banking restructuring process. The process might be painful, but the current crisis atmosphere offers a window of opportunity to press for changes.

Indeed, caution is needed in the banking restructuring process, in particular when taking into account the never-to-be-underestimated risk of a bank run. In that connection, we have strong concerns about the announcement date, the scope and the duration of the government guarantee. First, it seems to me that the authorities should avoid the worst situation when managing a crisis, that is, as elegantly put by Mr. Faini, having the worst of both worlds : having to bear the fiscal cost of the guarantee, while not benefiting from the confidence gains following the instauration of a guarantee. Second, the scope of the guarantee remains unclear, which may cause moral hazard issues that we certainly want to avoid. Third, the duration of the guarantee is also rather undefined, while risks may arise following the shift to the floating regime that will be gradually implemented in mid 2001, or should the exchange rate regime be put at risk by a higher than expected resurgence of inflation, or should the investors' confidence fail to be restored. All in all, I feel very worried with a guarantee which is closer to a "blank check" guarantee than of a blanket guarantee.

In addition, since the cost of the banking sector restructuring may happen to be sizable, full transparency will be necessary to avoid uncertainties on the ability of the government to support the process. I would be interested to know if Staff's assessment of the banking recapitalization costs converge with the assessment of the BRSA.

PSI is clearly a key element for the success of this program. A little more detailed information on private sector flows could have been expected in this report, and I would be grateful to Staff if, following Mr. Collins's suggestion, more precise information could be provided to the Board in the course of the next program reviews. In the same vein, daily information provided on the rollover of interbank lines is certainly useful, but benchmark information on what we expect would give us more sense of perspective on the actual PSI. It would also be important that the Fund's communication to the public, after this Board, puts a strong emphasis on PSI issues. Lastly, it

seems to me that should the creditor banks' response become less positive in the future than they are now, the Fund should revisit the PSI issues.

Another point on growth: it seems to me that the Turkish authorities privilege less optimistic growth assumptions for 2001 than the Staff. I would be interested to know what consequences could be expected from a lower than expected growth in 2001 on the primary surplus, especially given the existence of related performance criteria in the program.

To conclude, now that Turkey clearly has a very strong support from the International financial institutions, it seems to me that such a Christmas package must come together with strong new year's resolutions from the authorities. The burden of proof now rests very much on their ability to deliver on structural reforms designed to bring a lasting reduction in government expenditure. On top of the agenda is the long awaited partial privatization of Turk Telecom, together with proper management rights. That is a key element to increase the role of market forces in the economy and to attract foreign capital, but it is also a test element to restore market confidence in the country's program, at a moment when markets are increasingly less tolerant to any negative news.

With these comments, I support the proposed decisions and wish the best to the authorities in their endeavors.

Ms. Lissakers made the following statement:

Like many others, we noted the high risks of this program going in to Turkey I. We certainly agree that the program has delivered very substantial gains both in terms of growth and the desired reduction in inflation, until the authorities faltered significantly when tested in November. The objective of this new and larger program is to try to recapture the gains made without running even larger risks. We expect to do this by restoring discipline on the monetary front, restructuring the banking system, so that the government can actually afford to exercise the financial discipline that is central to the success of this strategy over time, and accelerating privatization in order to both reduce government costs and to draw in foreign exchange.

The fact remains that, as others have noted, the hybrid exchange rate regime will continue to carry large risks, and it certainly would not be our first choice, but we recognize that the Turkish authorities have demonstrated—not just stated—renewed commitment to carrying out the program and living with the discipline that entails. So, we are prepared to support this enlarged package.

But, I do want to stress the areas that are of particular concern to us, where we think close watch needs to be kept. Monetary policy is central. I

think there is a need both for discipline on the part of the authorities and clarity of information. Market investors are watching the NDA numbers very, very closely. The targets for NDA reductions for January and July are quite ambitious, and I hope that our presentation in the letter of intent will be very clear. I am concerned that there may be a bit of confusion about the December 31 performance criteria, which is not actually a target, but an average. I have spoken to staff about this, and I am sure that they will find a way to take care of it.

The larger concern on monetary policy is the one that Mr. Esdar, among others, noted, which is the question of whether it is being over burdened. The letter of intent says that the monetary policy after July 1 will be based on inflation targeting, and explicitly not on exchange rate targeting. We support this objective. But the fact remains that the report also says that flexibility of monetary policy will be very limited, as the exchange rate band will remain very narrow. Market analysts have likely to wonder how these two pieces fit together; so do my authorities.

On interest rate policy, the program's sustainability is highly sensitive to interest rates coming down rapidly in the first quarter. If they do not, of course, the banks will be under even more stress, and the government will face extremely high financing costs, as it has to roll over about $11 billion dollars in domestic debt in January and February alone. The government may also face a more difficult external financing environment in 2001, not just because of Turkish developments, but market developments, generally. I wonder if staff would have any additional comments on the prospects for the interest rate trajectory.

On the inflation forecast, it does seem fairly optimistic, and the targets set out in the letter of intent are even lower. There is some concern that the markets will not find them credible. We also think there is a risk that, while we understand that inflation targets are meant to shape expectations and influence behavior, including in wage negotiations, embedding unrealistic inflation targets in this program could lead to an incorrect path for the exchange rate and result in further real appreciation.

Which brings me to the heart of our concerns, which is exchange rate policy. It is inherent in this kind of regime that there may be excessive real appreciation of the currency. Now, the original staff projections were of real appreciation of up to 10 percent over the three years of the program, which as I said, would be sustainable. The staff estimates now that the real appreciation has already exceeded 10 percent in the first year, and will be greater still next year even if the program is followed as planned. I wonder how much more real appreciation the regime could sustain without requiring major rejiggering.

The planned transition from a crawling peg to a flexible exchange rate regime with gradually increasing but very limited flexibility is also problematic. If equilibrium has not been restored in the economy, there is a significant risk that the exchange rate will be pinned to the most depreciated side of the band for sometime, as was the case in some Latin American and Asian countries. Could staff and management comment on this? This raises a question about whether the current exit strategy requires redesign.

The risk of pressure on the exchange rate during the transition in midyear is clearly the greatest, which reinforces the worries about the open foreign exchange positions of the banking sector, to which I alluded earlier.

Just to come back to the point I made this morning, the reason I asked about the safeguards in the program is that it is one thing to say, well, the banking supervision system was weak. We knew that, and it was going to take time to get it in shape. What concerns me is the fact that the open foreign exchange positions of the banks worsened significantly during the time of the Fund-supported program. In fact, the dollarization and deposits and loans were fairly evenly matched at the beginning of the program. But, the foreign exchange denominated loans in the total domestic lending decreased from 43 percent at the end of last year to about 32.5 percent by October, while dollar-denominated deposits increased from the low 40s to 44 percent. So you actually had a very significant widening of the currency mismatch, and the question was really getting at could we have embedded better safeguards in the regime at the outset to prevent this from happening? And secondly, are we embedding safeguards now to prevent it from being repeated, or becoming worse? In fact, are we going to have an effective shrinkage of the open foreign exchange position and keep it that way?

On the restructuring of weak banks, as we know, this can be a very messy affair. I think that there is a plan which seems credible. I have a question on the liquidation. We have seen both financial and political fallout from messy liquidations and disputes about the valuation of disposed assets of banks that are being liquidated. There tends to be much second-guessing and political back-biting. I wonder whether, based on our experience in other countries, the Turkish authorities have given any thought to, or staff has discussed with them, the possibility of buying a little insurance against that likely scenario by asking at the outset for a second, possibly a third opinion by a neutral party in assessing the value of the assets of each bank that is to be resolved. Just to have it as a check, it might provide some guidance for the disposition, but at a minimum it will provide some probably valuable political risk insurance going forward for the authorities.

On information, we are already getting a lot of questions from investors on the fiscal cost of the bailout of the banking system, and I wonder if we are providing enough information on that. I realize that it is hard to get a

precise fix at this point, but this is an area where more information to the markets is better than too little information.

Like others, I am concerned about the interplay of the guarantee, which we have not yet clearly defined, and the continuation of the foreign exchange regime and the possibility that the bank regulatory supervisory agencies are still not going to be totally up and running and as effective. I agree with the First Deputy Managing Director's statement that it is ultimately up to the authorities, but we are making a very large bet here on the fact that all of these complex pieces are going to hang together, somewhat better than they did this past year.

On the question of publication, I have to say I think the Turkish authorities are making a big mistake in not publishing the staff report. The staff report, I think, gives a very clear, concise, presentation of what happened, why there was a crisis, and what is being done to fix it. It is much clearer than the letter of intent, and I think it strengthens the authorities' hand, it strengthens the credibility of this expanded program if investors can say that the authorities have got a good, credible story about what went wrong, they really understand what went wrong, which means they probably understand how to fix it. Vagueness, of which I think there is some in the letter of intent, undermines that credibility. I hope that at least the Chairman's statement will draw on some of the precision in the staff report that is lacking in the letter of intent, in presenting this new program to the public.

Finally, I am concerned about the lack of specificity on performance criteria in the letter of intent itself. Performance criteria are a lot better than they appear if one is limited to reading only the letter of intent, and again this goes to market reactions. I would suggest at a minimum that the presentation that is in Table VII in the staff report be added to the letter of intent or to whatever is published so that investors can see better the quality of this program.

Mr. Lehmussaari made the following statement:

Let me say first that this chair supports the staff's proposal and Turkey's request for the use of Fund resources under the Supplemental Reserve Facility (SRF). This is a major initiative to support economic reforms in Turkey.

As Mr. Deppler already explained, Turkey's three-year stabilization program, launched in December 1999, aimed at disinflation through fiscal adjustment and structural reforms while the monetary framework was characterized by a crawling peg regime. With the benefit of hindsight, one can now say that inflation expectations did not decline as fast as hoped, despite the fact that fiscal targets were met.

Due to high and sticky inflation expectations, real interest rates may have even turned negative with well known consequences. Therefore, the program, that some of us thought could lead to a contraction of the economy, in fact, evidenced an explosion in domestic demand with a rapidly deteriorating current account. The staff rightly points out that the contingent fiscal measures could have helped to mitigate the pressures, but frankly I don't believe that the authorities could have done a lot with fiscal policy since real bank credit was already increasing rapidly, nearly 25 per cent in the first 7-8 months of the year as shown in figure 6 in the staff report. Moreover, monetary policy was locked to preserve a crawling peg. Here I repeatedly ask myself what instruments the authorities could have used in order to contain this sudden problem.

The staff's paper provides a candid analysis of the main reasons which triggered the crisis. However, it is fair to ask what role the initial design of the program played in this process. Could we have avoided the crisis if our knowledge of the disinflation process would have been better? The downside risks of the program were explicitly discussed at the time of the program's approval, in particular as regards the inflation target.

This being said, I agree that the response of the authorities in implementing contingency measures was slow even when mounting evidence of overheating emerged. Even more regrettable is that many of the measures in the banking sector were only taken after delays. The weaknesses of the banking sector resulted in a full-fledged crisis.

The fact that some of the Turkish banks were cut off from interbank liquidity appears to be rational. This is exactly what you should expect when some of the counterparties start to lose their credibility. However, the Central Bank's response to pump liquidity to the whole system was very much misplaced. It only helped to finance the capital flight.

A few remarks on the program. On monetary policy, I welcome the authorities' intentions to withdraw the excess liquidity from the banking system. This is necessary but not necessarily a sufficient measure to alleviate the potential pressures in the foreign exchange market. The authorities' desire to continue with the crawling peg arrangement well into the next year raises some concerns. I would have liked to see a faster pace in increasing the flexibility of the exchange rate. Most importantly, the authorities should make a careful assessment whether to engage in foreign exchange interventions. The Fund money should not be used to finance interventions.

On fiscal policy, increasing the primary surplus is most welcome but the public sector borrowing requirement still continues to be substantial. In this context it amazes me that an average maturity on domestic public debt is only less than 1.5 years. This is, of course, of great concern. I would like to

ask the staff for the origin of this very skewed maturity profile and what the Fund staff has done in the past to tackle this problem.

On privatization, I agree that privatization is crucial to increase the role of market forces in the economy and to attract foreign capital to pay off government debt. In the case of Turkey, it appears that the markets are expecting that the authorities demonstrate their political will to take tough decisions through privatization. At the same time, however, we have to recognize that it may turn out to be extremely difficult to sell Telecom equities in Europe at this particular point of time when the market is already flooded with such stocks, as Mr. Faini has already noted.

We put particular emphasis on the banking sector reforms, which should not be allowed to be delayed. All banks that are not able to close their books at the end of the day in the interbank market should be brought under the administration of the SDIF. Very difficult decisions are needed, but once those decisions are taken, the Fund staff can be of great help in cleaning up the system.

I cannot stress enough the importance this chair gives to private sector participation in this exercise, and we would have liked a fuller account of the private sector involvement in the staff report. The early signs of Turkey's creditor banks to maintain their trade and interbank exposure to Turkey are encouraging.

Finally, I share the staff's assessment that there are large downside risks to the program and the exit strategy is extremely important. Without new private capital inflows the Turkish domestic rates will remain too high. I am afraid that at the current level of rates we are likely to see more problems in the banking sector. What is more, the government's refinancing needs are massive. Already in January and February next year refinancing needs from the domestic market amount to the equivalent of $11-12 billion. While the SRF arrangement buys some time for the Turkish authorities and the probability for immediate devaluation is lower than a few weeks ago, the Turkish authorities have a very rough road ahead.

On publication I very much share the views that Mrs. Lissakers expressed.

Mr. Junguito made the following statement:

Our Chair would like to give full support to the staff recommendation and the authorities' request to approve completion of Turkey's third and fourth program reviews and to have access to the IMF resources under the SRF, as well as to the proposed modifications of the relevant end-December performance criteria. We shall concentrate our comments on macroeconomic

and financial issues that, in our view, would be helpful to restore the credibility of Turkey's economic program.

Stabilization Dynamics. The path observed in Turkey since the beginning of the program seem to be similar to those observed in exchange rate-based stabilization process in other countries. Rapid expansion of domestic demand fed by favorable expectations and expansion of credit led to a deterioration of external accounts and prices in non-tradable grew faster than the tradable sector goods. Strong domestic demand together with high energy prices might have prevented inflation to fall more rapidly. Fiscal tightening as an instrument to contain demand would help. Perhaps, a stricter monetary policy would also have been in order.

Current Account and Exchange Rate. We share the staff's view that, at the macroeconomic level, there is an urgent need to adopt policies to reduce the current account deficit, and that further fiscal tightening would help to constrain domestic demand and help correct the current account imbalance. We consider that the type of the exchange rate regime should be the country's own choice and that a country's program should be structured in a way so as to make that exchange rate regime viable, an effort that is actually made in the proposed program. Notwithstanding, we would like to note that the adoption of a more flexible exchange rate regime would require other fundamentals to be in place and is less costly in terms of volatility when it is undertaken without immediate competitiveness problems, as our experience shows.

Inflation targeting. In a high inflation economy, in which indexation is a well- established practice, all prices tend to be led by a common indicator, most frequently exchange rate. In such a circumstance, a stabilization program anchored in exchange rate can be seen as an inflation targeting regime in a very narrow perspective, as reduction of price increase means reduction of exchange rate depreciation. In order to de-index the economy and to contain excessive increase in prices of non-tradable goods, there is a need for fundamental changes in the economy through reforms to break the inflation inertia, to prepare the supply side to a regime of lower inflation, together with radical changes in fiscal regime and a more active monetary policy. We consider quite appropriate the authorities' proposed future move towards a full inflation targeting framework. It will act as an anchor for inflationary expectations. For a successful inflation targeting framework, it is essential that the annual inflation target be credible and achievable. The experience of Chile is a worthy example of credibility.

Fiscal policy. Another point that we would like to raise regards fiscal policy. We share the staff and the authorities' view in regard to further fiscal tightening in 2001. We consider that in the case of Turkey a sustained fiscal tightening is required, above all, as a tool for debt management, for the reduction of the public debt-to-GDP ratio as the LOI recognizes. In fact, the

net debt of the public sector is quite high, particularly that of domestic public debt, and it is a motive of crowding out of the private sector.

Banking system. As the staff paper and Mr. Kiekens and Mr. Cakir indicate, the uncertainty and the run on the currency observed last November were linked to the market uneasiness about the condition of the banking system and the perception of a liquidity crisis affecting a few domestic banks. In such circumstances, we should welcome the authorities' strategies directed to reassure investors that lending to domestic banks is safe and that actions have been taken to establish a government commitment to guarantee all liabilities of Turkish banks. More importantly, it is necessary that the investors be assured that the banking system is solid and well capitalized and that its weaknesses are being addressed. Appendix I of the staff report gives some explanation as to the structure and financial characteristics of the banking system, which indicate that, despite problems with a few banks, on average, it is well capitalized, that non-performing loans are relatively low, that the profitability of the private sector is good, and that regulations and supervision are being strengthened. We believe that the IMF and the Turkish authorities should make public these positive characteristics of the financial sector. Notwithstanding, we consider important the strengthening and a rapid restructuring and consolidation of the weaker banks as a precautionary and defensive position in view of the turbulent external environment still ahead.

We commend the staff and the authorities for their prompt reaction to address the problems and safeguard the stabilization process. We wish the authorities well in their future endeavors.

Mr. Bernes made the following statement:

Let me start off by staying how impressed I was with the quality of this staff report. No doubt it was written under very tight time constraints. I would therefore like to join others in recognizing the exceptional effort of the staff involved in its preparation as well as the efforts of staff and management in responding to the crisis more generally.

I particularly appreciated the clarity with which staff described the background of, and events leading up to, the recent economic crisis in Turkey. Here, they make it clear – and Mr. Deppler has reiterated - that while external developments may have presented additional and perhaps unforeseen challenges for the authorities, it was in the end, the authorities' failure to stick to the program at a critical juncture and - when conditions began to deteriorate – their actions in direct opposition to the advice of Fund staff, that precipitated the financial crisis to which this revised program is responding.

Mr. Wijnholds, in his insightful statement, speculates that in seeking to understand why Turkey experienced the crisis while under a Fund program,

"it is more likely that the patient did not fully follow the prescription given by his doctors" and, I would add, delayed taking corrective action. I say this not to apportion blame as it is all too easy for us not involved in the crisis to do so. However, since we are dealing with the issue of how to restore confidence, it is essential to show that the lessons from recent events have been learned and internalized. I therefore share Ms. Lissakers' and Mr. Lehmussaari's sense of the importance of transparency with respect to the program that goes beyond simply publishing the letter of intent.

In this regard, I should note that I was disappointed in reading the preliminary statement by Messrs. Kiekens and Cakir that there was no sense of an acknowledgement that the authorities bore any responsibility for the program going off track. I appreciate that, as Executive Directors preparing statements on behalf of our authorities, we are sometimes called upon to reconcile our authorities' sensitivities with the need to remain consistent with the analytical rigor of the staff's work. This is often a difficult task. But, as in this case, the credibility of our views and our ability to regain confidence often hangs on our willingness to recognize past failures..

I will try not to repeat the points made by other Directors, particularly those emphasizing to the authorities the importance of complying fully with both the letter and the spirit of the program. As a general comment, I can associate myself with many of the views expressed by Messrs. Wijnholds, Cippa and Collins in their frank and insightful statements, particularly those with respect to the central role of the banking sector in the program and the need to avoid further unnecessary delays in dealing with intervened banks. There are only a few additional issues upon which I would like to comment.

On the delicate issue of exchange rate policy, the analytical leanings of this chair are well known, as hopefully is our willingness to support the innovative hybrid approach of an exchange-rate based stabilization with a built in exit strategy that was a central part of the original program. To the extent we had doubts that the strategy would work, they were based on concerns that the authorities' policy efforts might not be sufficient to bring down inflation fast enough for the peg to be sustained. We did not expect that the program would fail due to the absence of sufficiently supportive or even consistent macroeconomic policies.

That aside, when it became apparent that inflation was not coming down as quickly as expected and that the framework was coming under pressure, rather than call for its abandonment, we recommended that consideration be given to modifying some of the program's parameters – for example, the announced rate of crawl or the date at which the band would begin to open. Looking forward, and like Messrs. Zoccali, Wijnholds and others, we would again urge flexibility – if not in the exchange rate – than at least in the framework adopted, so that if events do not unfold as we hope they

will, we can find the least disruptive path forward. Suggestions like that of Mr. Wijnholds – that the band, when it begins to open, could be widened at a faster rate than just 15 percent per year – should be kept under consideration.

What I do not see as constructive are apocalyptic predictions of the consequences of a float. Mr. Kiekens argues in his statement that a float would have been "disastrous" and the "disinflation program and its achievements would have disappeared overnight with severe damage to the banking and corporate sectors. In my view, this is an over statement. Indeed, page 48 of the staff report suggests that the banking sector is rather more resilient to large currency devaluation. No doubt, if the authorities simply floated their currency – without strong and supportive structural and macroeconomic policies – disaster would ensure. But this is clearly also the case with the current exchange rate regime.

We do not know what would have happened had we pursued what the MD referred to as "Scenario II". We may yet find ourselves there, even despite the authorities' best efforts. In this regard, I do not take much comfort under current circumstances from the use of econometric equations suggesting that inflation inertia has mostly run its course. One thing is for sure – if we ever do find ourselves in "Scenario II", a coherent framework of strong macroeconomic and structural policies will be necessary. If we discredit this option now, we do ourselves a disservice. We do not need to burn bridges unnecessarily.

On the issue of PSI, I can be brief. I welcome the success the authorities are having in convincing foreign creditor banks to voluntarily maintain their exposure to Turkey. The continuation of this success is highly desirable as it avoids the need to consider other modalities of achieving the requisite degree of private-sector involvement. It also enables the Fund to appropriately play a minimalist role as far as Turkey's relations with its private creditors.

Finally, on incomes policy, I am quite concerned about the ability of the authorities to deliver satisfactory results on this front. As staff note, incomes policy was an important source of weakness in the original program and is a key vulnerability in the strengthened program. I would therefore welcome any reassurances that either staff or Mr. Kiekens may be able to provide with respect to the authorities' ability to achieve outcomes consistent with those envisaged in the program.

Mr. Mirakhor recognized that there were a variety of views on the exchange rate system. However, it was essential that any doubts about the exchange rate system or sustainability did not become public, as that could lead to a self-fulfilling prophesy and severe difficulties. It was important to maintain the solidarity of the Board' consensus behind the decision to support the authorities program.

Mr. Al-Turki made the following statement:

Let me start by joining others in commending Management and Staff for their efforts to assist Turkey in addressing this economic crisis. The speed in reaching an agreement to strengthen the program and the level of financial support under the SRF are impressive. This support is justified by the strength of the program which I hope will help strengthen confidence in the Turkish economy soon. In this regard, it is important to fully recognize the substantial risks detailed in the staff paper. Therefore, it is essential to implement the program fully as further slippages could be detrimental to confidence.

That said, it is encouraging that the agreement on a program with Turkey along with the announcement of a number of reform measures, including the strengthening of the fiscal accounts, helped stabilize the situation. The response of the private sector, as evidenced by the high rollover ratio is also reassuring. The challenge now is to convert this early progress into sustainable improvement. Here I will make few comments.

In view of the authorities' exchange rate regime, regaining confidence and achieving sustainable growth is predicated on a sharp reduction in inflation as well as improvements in productivity. However, despite the progress made last year, inflation in Turkey is unfortunately well above the program target. Indeed, this deviation along with the widening current account deficit were important contributing factors to the loss of confidence.

On the fiscal front, the tightening envisaged for 2001 is a welcome step. Here, the importance of adhering to the agreed incomes policy cannot be overemphasized. The authorities will also be well advised to monitor the situation closely and introduce additional measures if needed.

In the monetary area, I endorse the policy to move NDA gradually closer to its mid-November 2000 level. Here, I agree with staff that this should facilitate the recovery of foreign exchange reserves while helping achieve the agreed inflation reduction. I also share staff's concerns that high interest rates for an extended period could undermine the banking and corporate sectors.

Turning to the financial sector, it is clear that restructuring the banking system is extremely important. Therefore, speeding up the resolution of the insolvent banks is a step in the right direction. It is essential, however, that the agreed additional measures to strengthen the banking system be implemented on schedule. Close monitoring and strengthened supervision are also essential to ensure that the risk exposure of financial institutions is contained.

On structural reform in other areas, it is encouraging that the authorities are fully aware of the damage to credibility caused by slippages in

this area. This should strengthen their resolve to implement the agreed policies in a timely fashion. In this regard, a completion of the sale of Turk Telecom will send a reassuring signal. Passage of the law to reform the electricity sector and strong progress in the ongoing work with the World Bank to reform and restructure a number of industries are also essential.

With these comments, I support the proposed completion of the third and fourth reviews and the request for use of Fund resources under the SRF and wish the authorities success in their economic management.

The Director of the European I Department stressed that the revised program included a major shift in the monetary regime. Up to the current day, the program had been based on currency board rules. That is, the authorities had no way of affecting interest rates through monetary policy. It was a given of the market, depending on the ebb and flow of confidence. With the Executive Board decision at the current meeting, the monetary authorities basically would have a ceiling for the path of NDA, and they had latitude within that ceiling. The degree to which they were below that ceiling was contingent on how things developed on the inflation front, in particular. If inflation and the current account were not correcting as rapidly as possible, then the authorities had the leeway to go below the NDA ceiling. That represented quite a change in the monetary regime in the original program, in which CBA rules had been there partly to induce the authorities to tighten interest rates when it was necessary. The staff had been concerned whether, in fixed exchange rate arrangements, the authorities tended to retain for too long the fixed exchange rate, without taking the consequences on interest rate. The CBA rule had been present partly to overcome that likely resistance. Given that the CBA rules had been broken with the egregious slide two weeks from November 22nd, the program had been reformulated so there is only a ceiling on NDA, together with a commitment on the exchange rate path. Depending on how the authorities made their choices on NDA, there might be more or less reserve accumulation, depending on what happens to money demand at the time. While the system is not over determined, there is a change in the system as of the revised program

Mr. Yoshimura expressed surprise that the fact of the fundamental change of the monetary regime had not been mentioned very clearly in the staff paper. Why had a change in the monetary regime not been considered when the real interest rates turned negative?

Mr. Esdar wished further clarification with respect to the revised monetary framework. What would happen if there were pressure on the exchange rate, and monetary policy had to react by tightening? What would happen to the NDA target? There would appear to be conflicting signals for the authorities. There was some history in Turkish reform programs over a long period of time that there was a kind of over determination of monetary policy. It was therefore important to be aware that wrong monetary interpretation of the monetary approach had contributed to problems in the past. In that context, it was important to give the Turkish central bank a clear set of rules on how to deal with monetary issues. It was still unclear that one could have both NDA objectives and have an exchange rate target and also to increase reserves.

The Director of the European I Department, in response to Mr. Yoshimura's point, recalled that the First Deputy Managing Director had noted that the primary objective of the program had been to achieve disinflation and fiscal sustainability. To underscore that point, it was interesting to note that the debt ratio in Turkey had increased by 18 percentage points of GDP in 1999one year. Thus, the primary purpose of the program had been to save Turkey from the ravages of debt dynamics that it had faced. In line with that, the program had had a strong exchange rate commitment and strong rules on monetary policy. On the exchange rate commitment, in the context of currency board rules, there was no scope for sterilization—either up or down. The agreement had been that the NDA of the central bank would stay within plus or minus 5 percent of base money of a certain level of NDA, which was itself constant. However, on November 22, it had moved to something like 35 percent of base money. With the authorities having flagrantly broken the rule for two weeks, the view was that, looking forward, the rule no longer had any credibility. Therefore, with the current program, there would be a move into a standard Fund monetary programming mode, that is, an NDA ceiling coupled with an NIR floor. Depending on circumstances, that NDA ceiling would mean that reserves would or would not increase, but there was no over determination. To the extent that the NDA tightening was sufficient to draw in reserves, then that would be accepted; in fact, that had been occurring over the past few weeks. But to the extent it was not, then the authorities would be expected in effect to move below the NDA ceiling, in order to achieve the monetary tightening that was required to meet the inflation targets. The reserves were a residual consideration in this setup.

Mr. Esdar remarked that, in the case of pressure on the exchange rate through an inflow of capital, there would be this tight NDA target, which could result in an increase in reserves. The authorities would be presented with two options: they could sterilize the intervention, which would not negatively affect the NDA target, but would also not counteract the appreciating effect on the exchange rate. The other case would be that the inflow was not sterilized, thereby maintaining the exchange rate peg, but putting pressure on the NDA target. There appeared to be some inconsistency with the monetary framework.

Mr. Collins wondered about how the authorities would implement the transition to the inflation targeting regime.

The Director of the European I Department responded that, in terms of the transition to inflation targeting, the program featured a widening of the band starting at midyear 2001. Clearly, in the initial phases, that widening of the band would not be large enough to permit the standard inflation targeting framework. The intention was, in this transitional period, to have an NDA path for the period starting from the middle of the year, which would be a proxy for the inflation targeting. As more latitude was attained within the band, then there would be a move into a full-fledged inflation targeting framework. This was inherent to the choice on the exchange rate regime, which had this gradual widening, and the purpose of that gradual widening was to make sure that expectations at the outset of the floating regime would be controlled before moving to the full float. Therefore, at the outset of the program, there would be full CBA rules, and there would then be a transition phase, which was a bit of a mixed breed.

The Chairman encouraged Directors to discuss the more technical aspects of the program with the staff in a bilateral manner.

The Director of the European I Department remarked that, on the delay on the issuance of the note on the guarantees, it was his understanding that the authorities were in the midst of preparing a letter, which would be circulated to embassies and banks, clarifying the details of the guarantee. The authorities' main intention for delaying issuance domestically was because they considered that the prime minister had given a full-fledged guarantee and they did not want to be bringing this subject up in the middle of festivities at the turn of the year. It was important to note that the guarantee was generally accepted, and it was striking to recall that the level of deposits had not moved during the crisis.

On the consequences of downside risks for the primary surplus, the Director said that the program would accommodate shortfalls in revenue due to the cycle, and there was an implication for the primary surplus.

On the prospects for interest rates, that was the key to the success of the program, the Director considered. Interest rates were basically a reflection of the confidence in the program. If they did not come down, then confidence in the program would be low, and the authorities would have to address that through revised policies.

The staff representative from the European I Department, in response to questions from Executive Directors, made the following statement:

> Mr. Esdar asked about the role of indexation on wages. I fully agree with him that this has always been one weakness of the program from the beginning. However, I want to stress, once again, that we have to distinguish between civil servants and public sector workers. The policy of catching up with inflation if it is higher than targeted applies to civil servants, but not to public sector workers. Perhaps this group is very important, because we are talking about blue collar workers that affect more directly the behavior of wages in the manufacturing sector. There is no intention for the government to apply ex post adjustment for inflation for these workers, which in the last two years benefited from very large increases because contracts were signed before the beginning of the program. Civil servants, on the contrary, in spite of ex post adjustments, had salaries in real terms cut by 13 1/2 percent on average in 2000, because of the beginning of the year the wage level was very low compared to the average of 1999.
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> Regarding the interesting question raised by Mr. Lehmussaari (would better knowledge of the disinflation process have helped) it would have helped, but we were against an objective problem. We knew that previous approaches to disinflation not based on an exchange rate anchor had failed and we had learned lessons from that. But, it was the first time an exchange rate based disinflation was attempted in Turkey. To the extent that one can believe into econometric equations, the econometric equations were telling us that,

based on the past behaviors, inflation would be higher than the target in 2000, but hope was to break the pattern with respect to the past and this happened only in a limited way. But there was an objective difficulty here of learning from the past, because there was no past attempt of exchange rate based disinflation in Turkey. There were, of course, in other countries, but the specificity of inflation in Turkey has not been seen in other countries - 20 years of inflation at 60-80 percent is not found in other countries.

Mr. Lehmussaari also asked about domestic debt management. The maturity of public debt in Turkey has always been very short. In a way, this was an advantage in the first half of the year, because it implied that the government benefited a lot from the decline in interest rates which helped restore fiscal solvency. Looking ahead, the authorities had to face the choice between trying to issue security long term, which would have proved very expensive, I believe, in 2000, because of the still very high uncertainty of medium-term developments, and the alternative of keeping relatively shorter maturity of debt. What they did find as a sort of middle way by issuing floating notes, which reached about 20 percent of the stock of domestic debt. Floating rates do not protect from interest rate risk, because they are indexed to short-term interest rates. At least they protect from the rollover risk, and maturities of about 2-3 years were used.

Regarding the issue raised by Ms. Lissakers, we estimated that at the beginning of the program the competitiveness margin was about 10 percent. We were expecting this to be eroded over three years; instead, it ws eroded in one year. In addition to this, one has to take into account that there have been external shocks, terms of trade shocks which probably reduced the equilibrium real exchange rate. So, there is an issue there. I do not believe it is huge at the moment. A lot depends on shocks whether the external are temporary or not.

The program had actually from the beginning two components in terms of incomes policy. One was the increase in civil servant wages, and the other was the minimum wage policy. They were both implemented. What we tried to introduce later on in the program with the first review was a more direct involvement of the government in the discussions with the private sector. As I noted before, the success in this respect was very limited. This is something that we have been pressing the authorities to do as much as possible, but it is something that is almost, I would say, impossible to pin down in terms of performance criteria or other conditionality. So, it is more something that has to be done by the authorities on their own initiative:It is an issue of ownership.

The Chairman noted that several Directors suggested that the authorities publish more information on the details of the programs, especially the structural reforms.

The Director of the European I Department remarked that the staff would be in favor of greater publication of the details of the program, but that was a question for Mr. Kiekens to consider.

The Director of the Monetary and Exchange Affairs Department, in response to questions from Executive Directors, made the following statement:

> Ms. Lissakers asked about foreign exchange positions and to what extent we know what is really going on. I touched on that earlier and mentioned that this is high on the agenda and we will come back to the quality of the numbers in the next mission. Also, we would take on board all the remarks on what needs to be more closely followed.
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> On the issue of what lies ahead of us when it comes to dealing with winding up troubled banks already in the hands of the SDIF, we have raised the issue with the authorities about getting various types of second opinions in the process. More generally expressed, the issue we have to deal with in the course of the spring is to make sure that the process is conducted in such a way that a decent structure is generally in place throughout the whole process, because this is going to come back again and again in various forms.
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> On the issue of the banking system being solid, on average, it is, if one considers the September numbers, but that is on average. Let me point out there that, roughly speaking, we can talk about three parts of the banking system: one third being small, privately-owned banks; they are actually the banks we are talking about today. That is the part of the banking sector which has been in trouble over the last weeks and also in the past. We have four, large, privately-owned banks, and they also represent one third of the system. These banks appear to be in good shape and not a cause of concern. Then one third of the system is state-owned banks in deep trouble, and they have been in deep trouble for a very long period of time, which is well-known, and it is just as urgent to deal with them as it is to deal with small, privately-owned banks in trouble. This is also recognized in the program.
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> When it comes to the cost of cleanup operations, these numbers are, of course, always hard to know exactly. They also sometimes, unfortunately, change over time. We do not have numbers from the BRSA; we have numbers from the World Bank and our own estimates in this. Looking at the numbers, $25 billion is what is expected to clean up the state-owned banks and another $10 billion to deal with the privately-owned banks. This clearly shows that the real problem over an extended period of time, setting aside the crisis management effort in the past weeks, is really the state-owned banks.
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> Having said this, it is important to point out that, if you look at the numbers, if you compare these numbers and what is going on with what has happened in other countries, this is not a major financial sector disaster; this is

a middle-level financial sector disaster. What this means, and also looking at the fiscal aspects of this, is that, handled properly, this is doable.

Mr. Kiekens clarified that the $25 billion to clean up the four state banks was already included in the fiscal stock of debt amount. Of the $10 billion needed for the private sector, already $6-7 billion had been paid and was already in the stock of debt. Therefore, perhaps about $3 billion would need to be added to the actual debt stock in order to cover the entire amount for the clean-up operations.

Mr. Wei made the following statement:

At the outset, we would like to thank staff for providing a well-written insightful paper and a series of briefings which have kept the Board informed of the situation and developments in Turkey during the recent weeks. We are also grateful to Mr. Kiekens and Mr. Cakir's for their very helpful buff statement, which assured us of the full commitment of the authorities to program implementation.

We congratulate the Turkish authorities for the emerged signs of stabilization and positive developments in the financial markets in the past days, which should be attributed to the determined measures taken by the authorities and their close cooperation with the Fund. Management and staff deserve commendation for their timely and decisive reactions during the recent financial turmoil.

Before the recent crisis, the program was implemented broadly on track. We agree with others we should learn from the lessons of the crisis, one of which is that slippages from the program can be costly in the context of a weak financial system. The authorities' prompt adjustment actions and firm commitment to restore credibility via a strict implementation of the policies and targets for the next stage of the program have affirmed our confidence in the success of the program. Therefore, we support the completion of the third and fourth reviews under the SBA, and support the Turkish authorities' request for using Fund resources under the SRF, taking into consideration its financial needs in the coming period.

With broad agreement with the staff appraisal, we would only make comments on two issues, namely, monetary and exchange policy, and structural adjustments including banking sector consolidation.

On the issue of whether to revise the current exchange regime at this conjuncture, I concur with the Turkish authorities. The positive effects of the regime in generating a stable macroeconomic framework have been significant and well evidenced in the past 11 months, although it could not be expected that it would play a decisive role in improving the weak macroeconomic fundamentals for the long term and the fragile financial

system in a short time. The regime was not the cause for the recent crisis, and is not expected to be an obstacle to the stabilization of the financial situation and the resolution of the problems. Therefore I support the authorities' position to persevere with the regime. We also share the view of the authorities that repudiating the exchange rate commitment would not only risk credibility but also deprive the system of the most effective nominal anchor. However, from a medium and long-term point of view, I join Mr. Mirakhor in concurring with the gradual move to a widening of the exchange rate band and an inflation-targeting framework.

On the structural front. The progress in agriculture reforms is encouraging. The privatization of state economic enterprises in this sector is expected to advance smoothly. It is encouraging to learn that there will be essential progress in the somewhat delayed privatization of the communications and energy sectors.

We acknowledge the progress made in banking regulation and supervision since the beginning of the program. However, the recent crisis indicates that the vulnerable banking system is still a source of risk, and more attention and efforts in this regard are necessary. The authorities' several pillars for banking regulation and supervision are very welcome. I noticed that one of the key actions taken by the authorities to restore investors' confidence is a commitment to guarantee all liabilities of Turkish banks. I wonder whether such a measure might have a moral hazard effect, and what are the requirements to cease the measure if it is only an interim to help prevent contagion and stabilize the situation. Staff elaboration is appreciated.

The fiscal performance this year has been strong. The envisaged further tightening in 2001 aimed at reducing the use of external saving and thereby narrowing current account gap is very welcome.

Before concluding, we would join the staff and Mr. Mirakhor, apart from the downside risks to the program, in emphasizing the great importance of a strict and prompt implementation of the program. The authorities are encouraged to take advantage of the hard-won calm from the recent turmoil, and the momentum built up this year to press ahead with urgent reforms in order to consolidate the framework for sustainable growth.

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

Mr. Shaalan made the following statement:

At the outset I would like to complement staff on a very well-written and frank paper for today's discussion.

Economic developments since the last board review of Turkey's arrangement under the stand by have been most unfortunate. The failure of the inflation rate to fall in line with program expectations, along with the absence of corrective action, have set into motion a chain of events that derailed the program within a relatively short period of time. The decline in interest rates, combined with stubbornly high inflationary expectations, helped fuel an acceleration of domestic demand. This, in turn, precipitated a sharp widening of the current account deficit. The high current account deficit, along with the significant increases in real wages, led to concerns over the potential overvaluation of the exchange rate. When the liquidity crisis materialized in November, the injection of liquidity into the market further weakened credibility in the exchange rate arrangement. Without sufficient confidence in the exchange rate arrangement, inflationary expectations are bound to remain high, potentially setting into motion a vicious circle.

Success of the current program, therefore, depends on the authorities' ability to implement decisive measures that would break the inflationary expectations. This will certainly be a difficult task given the precarious starting point following a crisis, and the fact that inflationary expectations are well entrenched given the country's long history of high inflation. The current program is the latest of many attempts at stabilization, and we share the staff view that failure of this program would "impart pervasive and long-lasting damage to any new attempt at disinflation."

The program before us, under the difficult circumstances, is a well-balanced attempt at restoring the economy to a path that will lead to growth with lower inflation. Fiscal and monetary policies are tightened with a view to tackling inflation more decisively. Structural measures are designed to strengthen the banking system, while also restoring credibility in the authorities' commitment to reform through a renewed privatization drive.

The exchange rate remains a key tool in the authorities strategy to engineer a reduction in inflation. Their ability to achieve this desired reduction will depend on their success at restoring full confidence in the exchange rate peg within a short period of time. Restoring a high level of confidence will require strict adherence to the timetable in reducing NDA, and preferably exceeding it where possible. Only through a durable reduction in inflationary expectations can interest rates decline to more reasonable levels, and thereby reduce the risks to economic activity, the banking system, and the corporate sector. If such confidence does not materialize relatively soon, interest rates will remain high and the assumptions underlying the program will need to be revisited.

Fiscal policy plays a key role in the authorities disinflation strategy. Although policy has been relatively tight, as evidenced by the primary

surplus, further tightening is clearly needed given the level of the current account deficit and the growth in domestic demand.

Fiscal tightening at a time when there is a primary surplus and growth is expected to slow down is bound to be difficult, and one can expect that pressures will arise in favor of a less stringent stance. The credibility of the authorities strategy as a whole hinges on resisting such pressures, even if minor. Sufficiently robust fiscal contingency measures are also needed to respond to unforeseen circumstances, including those that may arise as a result of the recent banking problems.

Decisive steps in reducing inflation is a necessary condition for enabling a reduction in interest rates, thereby helping ameliorate the difficulties facing the banking sector, and minimizing the potential for problems in the corporate sector. At the same time, the restoration of confidence in the economy, and the success of the disinflation strategy, will in turn depend on the authorities ability to implement a rapid response to the problems that have surfaced in the banking sector, including the resolution of the problems in the intervened banks. Recent development have clearly shown that the weaknesses are widespread, and not limited to a few banks. Tackling the inefficiencies, as well as the necessary consolidation in the banking system, will undoubtedly take time. The authorities' clarification of the de facto commitment to protect all depositors and creditors should temper risks of bank runs while corrective measures are being implemented. However, such a blanket guarantee can also introduce perverse incentives. We would hope that this policy can be revisited once uncertainties have subsided and a critical mass of reforms to the banking system has been introduced.

Slippages in privatization have been one of the factors underlying the recent confidence crisis, through their signaling effect regarding the authorities commitment to reform. The privatization of Turk Telecom is key, but comes at a time when the market for all telecommunication companies is weak. However, we are gratified to see that the authorities remain guided by the need to improve economic efficiency, rather than the need to raise revenues.

Finally, the risks to all elements of the program are many. Given the renewed commitment shown by the authorities, we can support the proposed decisions. In supporting a program of this exceptional size, we are also expecting exceptional performance in policy implementation. We wish the authorities well in the very difficult task that lies ahead.

Mr. Barro Chambrier made the following statement:

Let me commend the staff for their hard work on Turkey, and management for bringing this case on such short notice. I want at this stage to

welcome the recent bold actions taken by the authorities to mop up excess liquidity and to strengthen the domestic banking sector. As indicated by Mr. Mirakhor, Mr. Wijnholds and Mr. Faini, this commitment to reform, coupled with the support of the international community, should help restore market confidence and stop the deterioration of the financial situation.

I support the authorities' request for Fund assistance under the Supplemental Reserve Facility as a supplement to the current stand-by. In this context, I would join other Directors who pointed out the promptness to which staff has responded to the authorities' request. Since I agree with the thrust of the staff appraisal, I will emphasize two issues very briefly.

On the macro front, the authorities should tighten demand management and maintain prudent incomes policy so as to achieve a sustainable current account balance and to reduce inflation. Such a course of action would help preserve external competitiveness while supporting the current exchange arrangement, which the authorities want to keep unchanged for the time being. I agree with the staff, Mr. Faini, and others that it would not have been credible to move to a flexible exchange rate arrangement at the time of the crisis. However, I encourage more flexibility as soon as the financial situation stabilizes.

Second, on structural reform, the authorities need to accelerate the implementation of the envisaged reform in the areas of privatization and banking. As rightly underlined by Mr. Faini, Mr. Wijnholds, and other speakers, these reforms are essential to strengthening market confidence in government reforms.

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

Mr. Callaghan made the following statement:

We can be brief.

One of the lessons that has come out of this is that a weak banking system can be the Achilles' heel of any macroeconomic stabilization program. As has already been discussed this morning, a fixed exchange rate system and the incentive this can give to lax consideration of foreign currency exposures can add to the vulnerability of the banking system. But I think there is a broader observation from this. Anything that diminishes the incentive of banks to undertake appropriate risk management, both market and credit risk, puts an added dimension on the necessity for tight prudential control.

I would have added that one of the consequences of insuring all bank depositors, which the Turkish authorities have undertaken, increases the need

for tight prudential supervision, because of the moral hazard implications and because of the incentives it gives for risk taking. But, if I understood Mr. Deppler earlier, there is full acceptance of a de facto guarantee, which I think adds an extra dimension to the problem we have of lack of incentives in terms of appropriate risk management and concerns as to whether there is adequate prudential supervision.

The other concern I have, particularly with a very fulsome de facto guarantee, is that this insurance is meant to be temporary. I don't know how you exit yourself from such an arrangement. It would seem to take a very long time.

The staff rightly note that loss of confidence in Turkey and the pressure that can be put on the exchange rate can come from a variety of sources other than domestically-generated ones and, as such, without in any means trying to attempt to undermine the prospect of success of the program, I think it is realistic to realize that the benign environment and adjustment path envisaged in the program may not eventuate.

This puts added emphasis on the necessity of pursuing structural policies that may be necessary to facilitate a more flexible exchange rate, and there are two aspects of this I would highlight. A lot of Directors already have talked about the importance of incomes policy. I have the same impression that others did of trying to understand what exactly was this new incomes policy, particularly given the comments in the staff papers which Mr. Bernes had already identified that this was one of the key weaknesses of the earlier program. The earlier staff response to this question about what exactly is this new incomes policy and how the government would play a more active role in discussions to ensure appropriate wage settlements was that it is hard to pin down. This underlines weakness in the program of something central to its success because it is hard to pin down.

On the question of the quality of banking supervision, the quality of the banking system, the staff this morning talked about the difference between putting together the framework and the implementation of the framework. I am not sure how it should be described, but I think that there is a clear need to improve the quality of banking supervision. It is one thing to adopt appropriate banking standards in terms of supervisory criteria, but they can be superficial, and I think that is what we have seen in terms of Turkey's banking system in that it is relatively well capitalized, nonperforming loans appear to be low, profitability is good, and foreign exchange liabilities appear to be well within the maximum allowed, yet we know that the quality of the banking system was weak. It goes down to the quality of banking supervision and, in turn, the quality of the banking system.

I am not sure if it is a framework or implementation issue, but there is clearly a need to improve the quality of banking supervision, especially in a banking environment with banks and corporates in the same industrial financial group and the ability of banks to make very large loans to a single customer. I see considerable merit in the suggestions of Mr. Collins regarding the need for a regular audit of the balance sheet of risks carried out by the banks. What appears to be required is, on the ground, intensive supervisory involvement in testing the adequacy of the bank risk management systems, and so on. I hope this is what is going to be focused on in future missions.

Overall, we support the review under the SBA and request for resources under the SRF. We also support monthly reporting for the first three months, but suggest that we should reserve the decision as to whether to move to quarterly reporting until the completion of the first three months.

Mr. Jadhav made the following statement:

At this stage of the discussion, everything that needs to be said on the subject has already been said, and eloquently so. Suffice it to say for now that we wholeheartedly endorse the staff's recommendations and wish the authorities every success at this critical juncture.

Mr. Rustomjee made the following statement:

We fully support the review under the SBA and the use of SRF resources, as well as completion of the reviews. I have just two points.

Firstly, I would like to associate myself with the remarks of Mr. Esdar on the potential confusion of monetary policy contrasting the situation of a crawling peg with the envisaged period of increased flexibility in monetary and exchange rate policies from the first of July 2001 and later in 2002, when the exchange rate band is expected to widen more substantially. There is even more flexibility in controlling domestic monetary conditions than whether the authorities institute an inflation targeting framework to guide policy.

On this latter point, I see a long and arduous road ahead. Conditions conducive to an inflation targeting strategy are complex and demanding, and the hazards of entering such a system tend to be higher, the higher is the starting point of inflation. The stickiness of inflationary expectations is clearly an issue of priority action for the authorities. Although I defer to the far better judgment of the authorities and staff in agreeing to reduce CPI inflation to about 15 percent by December 2001, I wonder how optimistic this target is, given that the CPI rate is expected to come in at about, as I read from the staff paper, 38 percent this year, and given, as the staff have noted in Paragraph 10 of the document, that Turkey has had 25 years of high and persistent inflation, and also, inter alia, that the six-month backward indexation procedure is very

widespread. I am not ready at this stage to ask about the credibility of the inflation targets to end-2001, as the track record of performance of the authorities in many other areas has been very, very strong.

Now a point which I would also like to acknowledge. I think that staff and the authorities will need to look closely at the likelihood of this target being met by December 2001, when the exchange rate band opens around the preannounced path in early July 2001. Among the many ingredients which will need to be built into an effective inflation targeting framework, I would imagine, would be a high degree of transparency of monetary policy and accountability of the central bank. Here, it would be good to understand what is contained in the new central bank law which is proposed as structural performance criterion. Also, there would be a need to develop a satisfactory inflation forecasting system. Here, I would be interested to understand, not necessarily now but bilaterally, whether the forecasting system currently in place or forecasting systems that are currently in place for inflation are in fact robust.

On the inflation targeting system, all of this would lead me to suggest a cautious approach in raising expectations that the country will be able to move quickly and without complication to a formal inflation targeting framework. I would urge that a realistic time frame be applied in making this leg of the transition. I note that MAE is providing technical assistance in this area, and I would urge that that continue, and assist the authorities to the extent that they require.

Secondly, I had concerns about the scope of the guarantee to creditors and depositors, as with other speakers. My concerns are very much of Mr. Faini's worst of all possible scenarios: Increased moral hazard, and lack of confidence in the utility of the guarantee. I am also uncomfortable in the description of the guarantee as being temporary but without an expiration date, particularly given the wide scope of applicability of the guarantee. I note that creditors are being apprised of the terms of the guarantee, but would urge the authorities to consider publishing the terms of the guarantee well ahead of the mid-January date proposed. I also share the comments just made by Mr. Callaghan on this.

The Director of the Monetary and Exchange Affairs Department remarked that, on the guarantee, it was important to keep in mind the conditions when this happened. Interest rates were between 1000 and 2000 percent. Then it had been necessary to decide what to do and what not to do, and whether there was time or not time to deal with the fine print. The alternative to doing nothing could have been the collapse of the payments system in the country. Alternatively, the central bank would have flooded the market with money, and the exchange rate mechanism would have been destroyed. In that situation, the judgment had been that, despite all the drawbacks, it was better actually to issue the guarantee the way it was done. It was impossible to know with certainty the counterfactual. Having put in place

the guarantee, what followed was a process that had to be handled very carefully, in which all the parties understood fully the risks involved. As explained by many speakers, the way to deal with moral hazard was clear. The were at least three critical issues. One was to strictly apply the SDIF rules, which basically meant that banks that did not behave properly would be taken over; that is a very forceful measure. The second issue was to conduct supervision as vigilantly and as efficiently as possible. The third issue dealt with how to exit these systems, which was when the markets had been convinced that the banks were performing well.

Mr. Abbott wondered about the possibility of a slightly larger dissemination of the information in the staff paper.

Mr. Kiekens made the following concluding statement:

> I thank Directors for their insightful comments and useful advice, which I will faithful report to the Turkish authorities.
>
> Today the Board has decided to give Turkey credit, for which I am very grateful. The amount of credit is large, and will indeed be very helpful in restoring the adequacy of Turkey's reserves and reassuring the markets. Even more important, with today's decision the Fund expresses strong confidence that the Turkish authorities are willing and able to implement their announced policies, and that their program is adequate to overcome the problems and achieve the economic goals.
>
> I wish to confirm that my authorities will fully honor this credit not only by repaying the money they borrow from the Fund, but equally important, by fully implementing their intended policies.
>
> As you yourself observed during the Board's discussion, Mr. Chairman, many Directors have used nice words to ask difficult things from the Turkish authorities. Allow me to remind the Board how gigantically ambitious were the tasks embraced by the Turkish authorities at the program's outset. A few numbers will illustrate this better than any lengthy discourse. Last year, Turkey's public sector borrowing requirement was 24 percent of GNP. This figure should be reduced to 10 percent by next year, and to less than 7 percent the year after. Turkey's operational deficit, which is the primary fiscal balance plus the real interest costs, stood at over 14 percent of GNP last year. Next year it will fall to 3.3 percent, including the cost of the banking sector restructuring, an item to which I will return shortly.
>
> It is gratifying to reflect that Turkey was broadly on track to achieving these very ambitious targets. This year alone, the primary fiscal balance improved by no less than 5 percent of GNP, and the real interest burden declined by 3.6 percent.

A considerable part of today's discussion was devoted to elucidating what went wrong. Mr. Deppler has given a balance analysis that explains the crisis. He was right to point to the three adverse external shocks outside Turkey's control: the increase in oil prices, the weakness of the euro, and the general rise in world interest rates. Although it is easier to find an explanation after the event, I can acknowledge that the staff had voiced concern about several worrisome developments before the crisis erupted. But the trigger of the crisis came as surprise to everyone. Rather than distrust of the macroeconomic fundamentals, or problems with commercial banks open foreign currency positions - to which the Board has devoted much time - it was a very classical interest rate risk arising from a maturity mismatch that suddenly struck a medium-sized bank when it lost access to short-term funding. I think it is fair to recognize that this type of risk had been underestimated by all, including the Fund's staff and the Board.

The most important operational lesson that I draw from this episode is that the Turkish authorities need a contingency plan for handling a liquidity crisis in an individual bank without upsetting broader market confidence. Mr. Lehmussaari was right to suggest that mechanism should be available to direct targeted credit to a bank in need while keeping the central bank's net domestic assets within the program limits.

Mr. Bernes disagreed with my view that a decision to float the currency would have been disastrous. I continue to believe that the firm commitment of the authorities to defend the exchange rate regime was and is still correct. I am pleased that this is also the view of Management and a clear majority of the Board. There was no way to be sure that a devaluation could be limited. Any overshooting would have increased the external debt to unsustainable levels, and greatly damaged the capital base of the banking sector. But the greatest cost would have been the severe setback this would have dealt to the disinflation and to the authorities' credibility.

Mr. Ingves has explained that the cost of cleaning up the banking sector is now estimated at $35 billion, $25 billion of which is needed to recapitalize the state owned banks and $10 billion for the private banks now in the portfolio of the Deposit Guarantee Fund. I can clarify that the $25 billion cost of recapitalizing state-owned banks and $6 billion for recapitalizing private banks are already included in the public debt numbers reported by the staff. In other words, the staff now estimates that the recent developments will add another $4 billion to the costs already provisioned, or 2 percent of GNP. Compared with the enormous costs, amounting to some 30 or 40 percent of GDP, of restructuring the banking sectors of some Asian countries, Turkey's costs are indeed "manageable." Moreover, the $25 billion cost for the public sector banks is the accumulated fiscal cost of a policy of subsidizing agriculture and small- and medium-sized enterprises, rather than losses due to imprudent bank management.

Ms. Lissakers suggested that the staff report should be published. I agree, and so do my authorities, that explaining the program to public opinion and the financial markets is crucial for maintaining public support and investor confidence. For this reason, they agree with the publication of their detailed Letter of Intent, and we encourage the Fund to issue an explanatory press communiqué. I am sure that the authorities will use material from the staff report as an excellent basis for their communication policy. But at this difficult juncture they do not wish to be the first country to publish a staff report on a program with the Fund.

Two Directors expressed some reservations about the amount of the credit, and referred to press reports that the market was surprised by its size. However, many observers and even some Directors underestimate the size of the Turkish economy, a tendency which must own something to the fact that Turkey's quota share clearly fails to reflect the true size of its economy. All in all, the additional $7.5 billion loan will prove a truly small cost for the international community to protect Turkey, many other emerging market economies, and Turkey's trading and financial partners everywhere, against major economic damage.

In closing, I wish to express my authorities' most sincere gratitude for the very professional work of the staff delivered in the shortest possible time in an exemplary fashion. I also thank you, Mr. Chairman, and Mr. Fischer, for your support in this difficult case, which has been handled well in every respect.

The Chairman made the following summing up:

Executive Directors noted that, while Turkey has achieved notable results in 2000, particularly in strengthening the public finances and in lowering inflation, the risks to the program since the completion of the second review have escalated - as evidenced by the recent crisis in the banking sector and the ensuing capital outflows and reserve losses. Directors considered that these developments were due in part to external shocks. A good part of the recent crisis was the result, however, of an accumulation of policy slippages, notably in the privatization, banking, and fiscal spheres. Against this background, Directors welcomed the recent strengthening of the authorities' program, particularly as regards fiscal policy, banking sector restructuring, and privatization. These actions should help restore market confidence and rebuild the credibility of the disinflation program. Directors accordingly supported the authorities' request for access under the Supplemental Reserve Facility in the proposed amount and the completion of the reviews under the Stand-By Arrangement. They welcomed the recent indications of support provided by the international banking community. Directors also commended the staff and management for their swift and able response to the recent difficult situation in Turkey.

Directors noted that policy implementation at end-1999 and in early 2000 had been nearly exemplary. However, thereafter the authorities failed to address in a timely fashion the emerging problems in the external current account and in the banking system. This, in conjunction with a departure in late November from the currency board rules that had been followed for most of 2000, led to a spiraling deterioration that had brought Turkey to the brink of a banking and exchange rate crisis. In light of this recent history, and taking account of the authorities' strong commitment to their choice of exchange rate regime, Directors emphasized the critical importance of two factors: first, the authorities should ensure that the agreed policies are implemented in full on a timely basis, and second, the authorities should prepare themselves to deal aggressively with unforeseen eventualities.

On the concrete elements of the current policy, Directors supported the authorities' twofold strategy for restoring confidence in the currency through steps to strengthen both the external position and the banking system. As regards the former, Directors viewed the substantial tightening of macroeconomic policies as essential. On banking, they welcomed the simultaneous commitment to provide an immediate assurance to depositors and creditors, on the one hand, and to strengthen discipline in the sector by reinforcing the supervisory effort and by strengthening the restructuring and consolidation effort, on the other.

Directors welcomed the tightening of fiscal policy envisaged for 2001 and regarded it as instrumental in achieving the required improvement in the external current account balance. They viewed the tightening as creating needed room for the government to honor contingent liabilities arising from bank consolidation. Directors also welcomed the timely enactment of the revenue measures envisaged in the program, as well as the authorities' commitment to keep the real growth of government expenditures below that of GNP growth, while improving its composition. At the same time, they noted that, should output growth fall significantly below the program target, consideration could be given to accommodating the resulting revenue loss if progress on the external current account and inflation proceeds as programmed.

Turning to monetary policy, Directors agreed that the gradual reduction of the excess domestic liquidity created during the crisis is appropriate, as it would help contain the exceptional buoyancy of domestic demand and help the rebuilding of foreign exchange reserves. A few Directors considered that, as confidence returns, there should be room for the authorities to lower interest rates, which would be beneficial for banking and corporate sector restructuring and for underpinning economic growth in general.

Despite some concerns, Directors endorsed the authorities' choice of exchange rate regime. They welcomed the authorities' intention to shift

gradually toward increased exchange rate flexibility as the exchange rate band is widened from mid-2001 on. In this context, they also welcomed the accompanying gradual shift to inflation targeting, as this strategy should help reduce uncertainty and facilitate declines in interest rates. However, several Directors considered that the authorities should not rule out the possibility of an earlier exit from the current exchange rate regime.

On incomes policy, Directors urged the authorities to follow through on their commitment to implement a strict wage policy for civil servants and for public sector workers. Directors also welcomed the authorities' commitment to play a more active role in facilitating agreement between the social partners on wage and price increases in line with targeted inflation.

Directors considered the authorities' announcement of a temporary guarantee for all depositors and creditors of banks incorporated in Turkey, and on the whole found this measure necessary for the preservation of the stability of the system. Put in the context of the package of measures to strengthen the banking system and its supervision, and to proceed, in an orderly way, with the deep restructuring that is needed, the measure was viewed as unavoidable during the transition, provided the restructuring continues apace. As any lingering uncertainty in this area could delay the restoration of investor confidence, Directors strongly encouraged early publication of detailed information clarifying the legal basis and scope of the guarantee.

Directors were encouraged by the recent approval of legislation that would facilitate bank mergers, and by the decision to lower the burden of reserve requirements and make loan loss provisions tax deductible. Moreover, they appreciated the commitment of the authorities to speed up the resolution of the intervened banks and urged them to execute the required actions without delay. They underlined that strengthening bank supervision regulations and implementation, and in particular intervening rapidly to isolate any troubled bank from the rest of the banking system, will be of paramount importance in the period ahead. They also urged that interbank flows be monitored for signals of possible future strains on the system. In this context, they welcomed the creation of the independent supervisory agency. Scrutiny of the quality of the forward cover used by banks to hedge their open foreign exchange exposure will be equally crucial.

Directors welcomed the renewed resolve of the authorities to revamp the privatization program and the new drive to liberalize key goods and services markets, including in the telecommunication and energy sectors. They regarded progress in these areas as key to enhancing economic efficiency, reducing public debt, and fostering the inflow of foreign exchange required for the smooth implementation of the program.

Directors recognized that there are significant risks to the program stemming from possible external shocks, inflation inertia, and possible slippages in policy implementation. They also underlined the importance of an early restoration of market confidence, which would help lower interest rates, thereby providing support to banks and corporations, safeguarding the budget, and protecting the economy from recession. Directors underscored that the policies envisaged should be implemented in a determined and consistent manner, and, in particular, that any premature easing of monetary policy should be firmly resisted. In the final analysis, Directors felt that there is no longer any room left for slippages.

The Executive Board took the following decision:

1. Turkey has consulted with the Fund in accordance with paragraph 3(e) of the Stand-By Arrangement for Turkey (EBS/99/225, Sup. 2) and paragraph 10 of the letter dated December 9, 1999 from the Minister of State for Economic Affairs and the Governor of the Central Bank of Turkey and has requested access to SDR 5,784 million under the Supplemental Reserve Facility.

2. The letter dated December 18, 2000 from the Minister of State for Economic Affairs and the Governor of the Central Bank shall be attached to the Stand-By Arrangement and the letter dated December 9, 1999, as supplemented, shall be read as further supplemented and modified by the letter dated December 18, 2000.

3. Accordingly, the Stand-By Arrangement for Turkey shall be modified as follows:

(a) the Stand-By Arrangement shall be augmented by the equivalent of SDR 5,784 million and accordingly, paragraph 1 shall be amended to replace "SDR 2,892 million" with "SDR 8,676.0 million" and paragraph 2(b) shall be deleted.

(b) paragraph 2(a) on the phasing of purchases under the Stand-By Arrangement shall be amended to read as follows:

> "2(a) Subject to paragraph 2(b), purchases under this Stand-By Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 2,843.80 million until January 20, 2001, the equivalent of SDR 3,933.12 million until February 20, 2001, the equivalent of SDR 4,800.72 million until March 20, 2001, the equivalent of SDR 5,379.12 million until May 15, 2001, the equivalent of SDR 6,179.24 million until August 15, 2001, and the equivalent of SDR 6,979.36 million until November 15, 2001, the equivalent of SDR 7,779.48 million until February 15, 2002, the equivalent of

SDR 8001.20 million until May 15, 2002, the equivalent of SDR 8222.92 million until August 15, 2002, the equivalent of SDR 8444.64 million until November 15, 2002."

(c) in order to identify which amounts of each purchase will be made available under the terms and conditions of the Supplemental Reserve Facility, Decision No. 11627-(97/123), adopted December 17, 1997, a new paragraph 2(b) shall be added to the Stand-By Arrangement:

"2(b) Of the augmented amount to be provided under the Stand-By Arrangement, the equivalent of SDR 5,784 million shall be made available until December 20, 2001 under the terms and conditions of Section I of Decision No. 11627-(97/123), adopted December 17, 1997, on the Supplemental Reserve Facility (the SRF), as follows:

(i) the equivalent of SDR 1,735.20 million, of the amount to be made available before January 20, 2001,

(ii) the equivalent of SDR 867.60 million, of the amount to be made available on January 20, 2001,

(iii) the equivalent of SDR 867.60 million, of the amount to be made available on February 20, 2001,

(iv) the equivalent of SDR 578.40 million, of the amount to be made available on March 20, 2001,

(v) the equivalent of SDR 578.40 million, of the amount to be made available on May 15, 2001,

(vi) the equivalent of SDR 578.40 million, of the amount to be made available on August 15, 2001,

(vii) the equivalent of SDR 578.40 million, of the amount to be made available on November 15, 2001.

To the extent that the amounts in this paragraph 2(b) are not purchased by December 20, 2001, the amount of the Stand-By Arrangement set forth in paragraph 1 and the cumulative amounts set forth in paragraph 2(a) shall be reduced accordingly."

(d) paragraph 3(a) of the Stand-By Arrangement shall be amended to add the following:

"(vi) the limit on the cumulative primary balance of the consolidated government sector, including privatization proceeds, set forth in Annex B to the letter dated December 18, 2000, or

(vii) the limit on the cumulative primary expenditure of the central government set forth in Annex C to the letter dated December 18, 2000," and, after the words "is not observed," to add: "provided that the conditions set forth in paragraphs 3(a)(i), and 3(a)(iv) through 3(a)(vii) shall not apply to purchases made before February 20, 2001."

(e) the performance criteria set forth in paragraphs 3(a)(i) through 3(a)(vii) of the Stand-By-Arrangement shall be as specified in the Annexes to the letter dated December 18, 2000, as follows:

(i) paragraph 3(a)(i): for December 31, 2000, March 31, 2001, and June 30, 2001, September 30, 2001 and December 31, 2001, as specified in Annex B,

(ii) paragraphs 3(a)(ii), 3(a)(iii), 3(a)(iv) and 3(a)(v): for December 31, 2000, March 31, 2001, and June 30, 2001, as specified in Annexes E, F, G, and H,

(iii) paragraph 3(a)(vi): for December 31, 2000 and December 31, 2001, as specified in Annex B,

(iv) paragraph 3(a)(vii): for March 31, 2001, and June 30, 2001, September 30, 2001 and December 31, 2001, as specified in Annex C,

(v) paragraphs 3(a)(ii) and 3(a)(iii): for January 31, 2001 and February 28, 2001, as specified in Annexes E and F.

(f) paragraph 3(c) of the Stand-By Arrangment shall be amended by adding the following regarding structural performance criteria:

(xi) by January 31, 2001, reaching agreement on revised plans for those banks under enhanced supervision that are not capital deficient, or

(xii) by January 31, 2001, enacting an Electricity Markets Law, as specified in paragraph 36 of the letter dated December 18, 2000, or

(xiii) by March 30, 2001, issuance by the tender committee of final tender documents and invitation for bids for Turk Telecom, as specified in paragraph 35 of the letter dated December 18, 2000, or

(xiv) by June 1, 2001, revoking the license of any bank for which no bid is submitted by April 24, 2001, or

(xv) by June 11, 2001, revoking the license of any bank for which no bid is accepted by May 7, 2001, or

(xvi) by September 30, 2001, effect sale, merger or liquidation of transition bank comprising the consolidation of assets of banks for which licenses have been revoked.

(g) paragraph 3(e) of the Stand-By Arrangement shall be amended after "November 14, 2000" to read "January 19, 2001, February 19, 2001, March 19, 2001, May 14, 2001, August 14, 2001, November 14, 2001, February 14, 2002, May 14, 2002, August 14, 2002 until the respective reviews contemplated in paragraph 62 of the letter dated December 18, 2000 have been completed."

(h) paragraph 4(i) of the Stand-By Arrangement shall be amended to replace subparagraph (d) with the following and to delete subparagraph (f):

"(d) pursuant to paragraph 1(b) of Decision No. 5703-(78/39) or paragraph 10(a) of Decision No. 4377-(74/114), or"

4. The Fund decides that the third and fourth reviews contemplated by paragraph 3(e) of the Stand-By Arrangement for Turkey are completed and that Turkey may continue to make purchases under the arrangement, on the condition that the information provided by Turkey on the implementation of the measures identified as prior actions in paragraphs 17, 35, 36 and 46 of the letter dated December 18, 2000, on recapitalization plans for the three undercapitalized banks under enhanced supervision, and on the public announcement of the tender documents involving the sale of 33½ percent of Turk Telecom to a strategic investor and the granting to the strategic investor of strong management control rights, is accurate.

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

Decision No. 12379-(00/129), adopted
December 21, 2000

3. MADAGASCAR—ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—DECISION POINT; AND INTERIM POVERTY REDUCTION STRATEGY PAPER AND JOINT STAFF ASSESSMENT

The Executive Directors considered a staff paper on the decision point for the enhanced HIPC Initiative for Madagascar, prepared jointly by the staffs of the Fund and the International Development Association (EBS/00/251, 12/5/00; Cor. 1, 12/19/00; Sup. 1, 12/5/00; and Sup. 1, Rev. 1, 12/21/00), together with the interim poverty reduction strategy

paper for Madagascar (EBD/00/105, 12/4/00) and the staff assessment, prepared jointly by the staffs of the Fund and the International Development Association (EBD/00/106, 12/4/00).

The staff representative from the African Department submitted the following statement:

> Staff want to draw Directors' attention to data reconciliation issues that have emerged on multilateral and bilateral debt data. Staff have received updated information from some multilateral creditors, which would result in a slight increase in the required assistance. Staff have not yet been able to resolve differences between the authorities' data and those provided by the Paris Club Secretariat. The latter suggest claims could be lower than the authorities' data presented in the decision point document by some $40 million in nominal terms, which the staff estimate to be about $20 million lower in NPV terms after traditional relief. This could imply that a lower amount of assistance is required under the HIPC Initiative than indicated in the decision point document.
>
> In order to allow the necessary time to resolve these issues, staff and management suggest that the Board approve IMF assistance based on a lower total assistance of $790 million, compared to $814 million in the decision point document, subject to a possible (upward) amendment once the figures have been reconciled. Total IMF assistance suggested for Board approval is thus $21.6 million rather than $22.1 million in the decision point document.
>
> Staff have been in contact with the Paris Club Secretariat and the Malagasy authorities, and undertake to complete the reconciliation as soon as possible - this process should take no more than 4-6 weeks. At that point, a correction to the decision point document and revised decisions would be issued for approval on a lapse of time basis to the Fund and Bank Boards. In the interim, it is suggested that the first installment of IMF interim assistance of $0.9 million be disbursed as indicated in the decision point document, and the delivery path of IMF assistance be adjusted later as necessary in light of the reconciliation.
>
> As the IDA Board has already approved the decision point in principle, it is suggested that the joint HIPC press release be based on assistance of $0.8 billion, and that the decision point document be posted on the website only after the reconciliation issues have been resolved and the revised Board decisions have been approved.

Mr. Barro Chambrier submitted the following statement:

> In support of their request for the confirmation of the decision point, and interim assistance under the enhanced HIPC Initiative, my Malagasy authorities are presenting today their I-PRSP. They would also like to point

out that they have completed discussions with the staff and have reached agreement on a comprehensive program of economic and structural adjustment which is consistent with the I-PRSP, and for which they intend to ask for Fund support under a new three-year PRGF, soon. This program builds on the progress achieved under past arrangements which have resulted in significant improvements in economic and financial conditions, including the strengthening of public finance, market liberalization, restructuring of the banking system and the exchange and trade system, and a comprehensive program of privatization. Overall, since 1996, Madagascar has established a good track record of policy implementation, and the reforms undertaken have been the basis for sustained growth within which poverty reduction can be achieved.

The preparation of the I-PRSP which was put under a specially formed technical secretariat has benefited from extensive discussions with the private sector, representatives of donors, government officials and a large number of civic organizations. The I-PRSP has also benefited from previous work done on poverty-related issues and sectoral strategies namely in the education and health sectors as well as rural development. In this regard, the I-PRSP has done an excellent job of analyzing the causes of poverty and in recommending specific actions and setting specific time frames for the implementation of a number of measures. As noted during the last Board discussions, poverty is a very severe problem in Madagascar, where about 70 percent of the population live below the poverty line, and the measures envisaged in the I-PRSP are aimed at relieving the hardships of the population, especially those living in rural areas.

Recognizing the strong link between growth and poverty reduction, the I-PRSP places special emphasis on measures that are aimed at further reducing structural constraints, and at improving economic growth. They view the achievement of an annual real rate of economic growth above 6 percent per annum as essential to achieve the poverty reduction objectives. While measures in the program are directly targeted at improving certain social sectors, the program also addresses factors that still hinder economic development. In this context, the process of structural reforms, including the privatization program already started, will be accelerated, and measures are being taken to address weaknesses in governance, transparency and accountability in the management of public resources. Thus, the authorities will continue their efforts to strengthen budgetary accounting and the control system as well as improving transparency in the use of public resources. The range of budgetary reform measures envisaged are outlined in Box 6 of EBS/00/251, and will be implemented steadfastly, some with external technical assistance. As regards the sources of growth, it is expected to come mainly from tourism, mining, agriculture and light manufacturing.

The decentralization process which will take place over the next 18 months should also help to improve the delivery of basic services to the rural area, as it will contribute to enhance consultation at the local level and help to deliver services more rapidly. The government will transfer responsibility for the delivery of such services as local roads, primary health and education to the provinces, as well as some responsibility for justice and police. To ensure control over expenses at the provincial level, a transfer of competence is envisaged, and the authorities will be putting in place a better budget oversight system, and will define clearly the decision-making power and administrative limits of the provinces.

The objectives of the authorities as outlined in the I-PRSP is to ensure that improved economic conditions translate into tangible results in terms of poverty reduction, job creation and a significant improvement in the economic welfare of the population. In this regard the resources that become available through the HIPC Initiative will be used mainly for education, health, rural development and basic infrastructure. Thus, the government intends to hire additional teachers, more health care providers and will use some of the resources for acquiring pedagogical material and medicine. Tables 5 and 6 of the Decision Point document give a detailed breakdown of the planned use of HIPC resources for the next three years. A Supplementary Budget will be prepared and submitted to the National Assembly. This budget will also be submitted to civil society organizations. In 2002 and beyond, the additional resources will be fully integrated in the budget and semi-annual reporting related to poverty reductions will be introduced to track the use of the HIPC resources.

My authorities are already working on the preparation of the full PRSP. Given the extensive work already done in the preparation of the I-PRSP, and the ongoing studies being done by international institutions and others, and the active consultation underway with social partners, the authorities are of the view that they can have the full PRSP ready by the middle of next year, and the document will also address the concerns raised by the staff. However, in the preparation of such a document, quality rather than time will be the guiding principle, and the authorities will only submit the document once they are fully satisfied that it meets the required criteria.

The updated DSA confirms that the debt burden of Madagascar will remain unsustainable, even after full use of traditional debt relief mechanisms, and will continue to constrain the efforts of the authorities to improve social indicators. With assistance under the enhanced HIPC Initiative, the debt-to-export ratio will fall to 136 percent by 2003 and below 100 percent after 2010. The debt service-to-export ratio and debt service-to-revenue will fall over that period, allowing for an increase in social expenditure, as outlined in the I-PRSP.

The authorities have also reached agreement with the staff on key policy measures linked to the floating completion point. These are outlined in Box 8 of EBS/00/251. They are fully consistent with the objectives of poverty reduction and those of the PRGF which will be submitted to the Board soon. The policy measures focus on achieving macroeconomic conditions which are considered basic to the success of the poverty reduction strategy. Measures in the area of governance and institutional reform are also part of the list of completion point triggers, as they are viewed as important to further enhance transparency. Specific measures to ensure the delivery of services to the poor are part of the set of triggers. Actions in many of these areas are already underway, but will be strengthened along the line specified in the I-PRSP so as to enable Madagascar to meet the criteria under the completion point.

In conclusion, I would like to reiterate the commitment of my Malagasy authorities to continue the adjustment process, and to indicate their appreciation for the invaluable assistance provided by the Fund. The assistance that will come from the HIPC Initiative will be of critical importance to Madagascar's poverty reduction efforts. However, the authorities would like to point out that their own efforts will need to be accompanied by donor efforts to deliver the required technical assistance and the necessary resources in a timely manner.

Mr. Djojosubroto submitted the following statement:

We thank the staff for the clear and well-written set of papers and thank Mr. Barro Chambrier for his helpful statement. Madagascar faces many economic and social challenges. Poverty is widespread, while resources constraints to resolve it persist. In addition, a series of cyclones that occurred in the recent past have deteriorated the existing adverse condition. However, given such a difficult condition, Madagascar's economy has begun to show improvements since 1997, leading to higher economic growth of 4 percent in an average with the manufacturing and tourism as the leading sectors. This improvement was also accompanied with subdued inflation. The authorities should be commended for their skillful management in steering the economy and for meeting all quantitative performance criteria set for end-June 2000 as well as all quantitative benchmark for end-September 2000 under the 1999-2000 PRGF-supported program.

Notwithstanding recent achievements, poverty in Madagascar remains a serious problem. We welcome the authorities for establishing the I-PRSP, that we believe, has in advance, covered appropriate measures needed to fight poverty. We note the broad and diverse involvement of the government and civil society in the preparation process of the I-PRSP. However, like staff, we are concerned that the I-PRSP document does not mention clearly how the poor and vulnerable groups are going to be included in this process.

We can go along with the authorities' view that high growth is indeed of utmost importance to fight against poverty. However, we are concerned about the ambitious target of 7 percent economic growth for the medium-term, as set out in the I-PRSP amidst the existence of downside risks, mainly associated with the country's high vulnerability to external shocks. In the past, the average growth rate was around 4 percent, much lower than that projected growth. As Madagascar is one of the ecologically significant countries in the world, we would like to stress the quality of the economic growth strategy to be environment friendly. This will be a critical factor to support the development of the tourism sector as the backbone of the Malagasy economy in the coming years. We concur with the authorities that the strategy for growth is centered around pro-poor growth in the rural agricultural area as many people derive their livelihood from mainly the agricultural activities. In this context, the focus of government's efforts on strengthening farmer associations, developing micro-finance institutions, promoting income-generating activities, and improving the rural roads network are in the right direction. Furthermore, we believe that efforts to provide a better irrigation in the rural area should be on the priority list of the program to lift up the agricultural sector's productivity that has stagnated over quite long period. On this issue, we would like to know the consequences of the existing unequal land distribution system on the agricultural productivity of Madagascar. Staff's comments in this regard would be helpful.

On the triggers for reaching the floating completion point, we can go along with those laid out in Box 8 of the staff paper. However, on the health area, it seems that quantitative figures need to be included as to provide a better monitoring. A greater attention on this area is needed as the performance of public health service utilization in 1999 declined compared with those in 1993. In the face of this problem, we welcome the authorities' intention to use part of the savings from debt relief to build a good monitoring system which would provide a proper baseline against which progress can be assessed in the coming years.

Despite using favorable macroeconomic assumptions, Madagascar's external debt condition is expected to remain unsustainable with NPV of debt-to-exports ratio at 248 percent in 1999 and 150 percent by 2008. As a consequence, Madagascar will need considerable financial assistance from the international community much beyond the medium term. It is hoped that the relief under the HIPC Initiative will help strengthen the authorities' poverty alleviation. The authorities have made considerable progress on adjustment and reforms, and are committed to an ambitious program of poverty reduction. Therefore, we can agree with the proposal that Madagascar reach its decision point for enhance HIPC Initiative before the end of this year. In this context, we can also support the staff's recommendation that the Fund and IDA could provide interim assistance.

Finally, in view of Madagascar's satisfactory performance under the PRGF-supported program, and the alarming problems facing the country, we support the proposed decision and wish the authorities success in facing their challenges.

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

After a weak start of economic reform efforts, Madagascar embarked on successive far-reaching reform programs since 1997 which produced some encouraging results in economic stabilization, structural changes, and growth performance. Nonetheless, extreme poverty continues to be wide spread and external debt remains unsustainable. In view of Madagascar's generally good track record and its difficult external debt situation, we support the country's eligibility for debt relief in the amount recommended by staff, and that it should be provided with interim assistance.

The completion point triggers listed in Box 8 are generally appropriate. However, as in other cases recently discussed in the Board, we have some concern about the social sector monitoring indicators in Table 4. As we indicated in the recent discussions on Niger, we have misgivings about the specific targeted reductions in the repetition rate in public primary schools which is not under the full control of the authorities. Having said that, we note that the case before us represents an improvement on recent cases, because the output targets are not explicitly included in Box 8 which lists the triggers, but are included in the monitoring indicators table and are set within range targets which allow some flexibility in the difficult task of adequately assessing performance in the social areas.

As regards the debt sustainability analysis, it is well to note that Madagascar's balance of payments is subject to considerable uncertainty due to its vulnerability to weather and market conditions affecting agricultural exports as well as to changes in the grant component of external financing. It is therefore important to regularly assess the country's external debt sustainability in order to adjust the amount of HIPC assistance if necessary.

The I-PRSP includes long-run targets as well as short-term concrete actions that the authorities intend to take in 2001 and over the next three years. We share staff's assessment that the components of the strategy and measures outlined in the paper are appropriate. The fact that some of these components reflect ongoing reforms should increase the chances for the strategy to succeed. We would, however, stress the importance of adhering to the program and continuing to strengthen the implementation capacity needed for its success, including through the provision of appropriate technical assistance. In this context, we share staff's view that prioritization of the long list of measures proposed in the I-PRSP will be necessary.

The I-PRSP appropriately places emphasis on improving the institutional set-up, enhancing the business law, and reinforcing the judicial system. This, along with the other structural reforms and stabilization efforts included in the PRGF-supported program, if successfully implemented, will help improve the business environment and enhance growth prospects. We share the view that the baseline growth rate of 7 percent may be overly optimistic and that the full PRSP should develop an alternative scenario based on more realistic assumptions. Furthermore, the full PRSP should be more specific in outlining the means and measures to exploit the untapped growth potential in various sectors and to spread income growth to the rural areas where most of the poor live. In this regard, special attention needs to be given to improving infrastructure and developing microfinance institutions.

Finally, we urge the authorities to stay the course in the implementation of their reform agenda and wish them success.

Mr. Rustomjee submitted the following statement:

We thank the staff for well written papers and Mr. Barro Chambrier for his insightful statement. Since we discussed Madagascar's economic situation, performance and debt burden last month, we will focus our comments on issues for discussion.

We support Madagascar's eligibility for debt relief and the timing of the Decision Point. The authorities have shown strong commitment to prudent macroeconomic policies and have undertaken an ambitious structural reform program, including extensive privatization. Output growth has been buoyed by these reforms, inflation has been reduced to the level of the country's trading partners and the external current account deficit reduced. Economic activity remained strong in 2000 and GDP growth rate accelerated to 4.8 percent, despite the damage caused by three cyclones. The authorities' performance under the PRGF program remained strong, all performance criteria were broadly observed and negotiations for a new PRGF are at an advanced stage. Debt relief for Madagascar is further justified by the heavy debt burden which, in Net Present Value terms, stands at 248 percent of exports of goods and services and by the widespread poverty in the country.

We note that there has been prolonged and intense consultation between all parties represented in the I-PRSP process, culminating in a set of completion points triggers well beyond the scope of what we have seen for other countries. This could be considered an encouraging sign as it shows a strong sense of ownership and also reveals the depth of the consultative process. On the other hand, the extensive schedule of completion point triggers could also be viewed as unnecessarily numerous and onerous for Madagascar when we compare with other countries. Our concern in this regard is that the authorities may ultimately comply with a critical mass of the

triggers but fail to meet all of them. Staff comment would be welcome on this issue and in principle we recommend that these triggers be scaled down and focused on critical issues and urge the Fund to adhere to its principle of uniformity of treatment among its members.

Madagascar ranks among the poorest countries in the world. Seventy percent of the population live in poverty, of which 80 percent are in the rural areas. The staff report rightly points out that the key to sustained poverty reduction in Madagascar is to raise rural living standards and recommends the need to improve rural roads and electricity while cautioning against environmental degradation. In paragraph 8 of EBS/00/251, the staff notes "rural poverty and living standards are partially related to access to irrigated land and that land distribution remains highly unequal with 1 percent of rural households owning 22 percent of total irrigated land". We view this as a serious impediment to growth and wonder whether the staff have any suggestions as to how this problem can be addressed. We see great potential for the poor to engage in irrigated tradables, with substantial contribution towards the reduction of poverty. Staff comment would be appreciated.

Staff project GDP to grow by 6.3 per annum, the terms of trade to remain stable and export volume to increase by 6.5 per annum, among others, in the period 2001-2019. These projections maybe too optimistic for a country that is highly vulnerable to weather conditions and dependent on primary exports, though we note the expected increase in manufacturing exports and tourism. In our view, it might have been valuable to have explored another scenario using assumptions more typical to year 2000, when the three cyclones damaged exports and infrastructure while imports increased because of reconstruction needs. However, we go along with staff recommendation to continue reviewing Madagascar's debt sustainability even after delivery of HIPC Initiative assistance. We also feel that the country deserves interim assistance, including from the Fund, to allow it to make inroads in reducing poverty.

There are two issues that concern us; (i) that some multilateral institutions may require bilateral financial support in order to deliver their share of assistance, and that (ii) there has been virtually no positive response from Madagascar's other bilateral creditors. We feel the authorities need assistance in these areas in order to expedite debt relief.

Mr. Lushin and Mr. Zakharchenkov submitted the following statement:

In line with the general spirit of the Board to streamline discussions of the HIPC cases, in our statement we will try to be brief. Moreover, we have already expressed our position on a number of HIPC-related issues for Madagascar on November 8, when the preliminary HIPC document was considered.

By the end of this year Madagascar remains on-track with its macroeconomic program under the PRGF arrangement, thus meeting one of the conditions for reaching a decision point in 2000. We note that the uninterrupted track record (1.5 years by December this year) is relatively small. At the same time, we have to be realistic and admit that this not the shortest track record among other HIPC cases where the decision point has already been approved.

We consider that the presented I-PRSP meets the criteria applied for such documents and could form a sound basis for a set of policies to achieve sustained growth and poverty reduction. We found that most of the remarks made by the donor community in the second aide memoire aimed at strengthening the full PRSP and outlined in the joint assessment paper (EBD/00/106, footnote 3) are, indeed, relevant and useful. Incorporation of these suggestions into the full PRSP should considerably strengthen the poverty reduction framework. We also noted with satisfaction that a number of bilateral and multilateral partners are willing to assist Madagascar in development and implementation of the full PRSP (EBD/00/106, paragraph 29).

The staff and the Malagasy authorities have developed, apart from the completion point triggers, a set of monitoring indicators to assess progress in the implementation of planned policy measures. This initiative appears to be very useful and we wonder whether it should be extended to other HIPC cases. Also, we noted that tracking of the use of interim debt relief will be conducted by submission of supplementary budgets to the Parliament for approval and subsequent monitoring of their execution. These measures should address concerns related to monitoring of the use of resources freed up by the HIPC assistance.

Concerning the issues for discussion, we consider Madagascar eligible for assistance under the enhanced HIPC Initiative. We agree in principal with the amount of assistance needed for Madagascar to reach a sustainable debt level. We also agree that triggers for reaching the floating completion point presented in Box 8 of the DP document are appropriate.

Finally, on reaching the decision point for Madagascar. As a matter of principle, we favor an early approval of this decision point. However, there remains an unresolved debt issue between Russia and Madagascar. While an agreement on the rescheduling of the pre-cutoff date debt was signed in October 2000, an amendment to this agreement stipulated that the problem of large post-cutoff date arrears should be resolved before the end of this year. On November 8, when we discussed a preliminary HIPC document, our support for the Madagascar's decision point was based on an expectation that a mutually acceptable solution to this problem was going to be reached as planned. Unfortunately, this expectation did not materialize. Therefore, in

accordance with the general position of the Russian authorities outlined in our recent statement on Guinea, we have to abstain on the decision point for Madagascar. This said, we confirm that as soon as the problem of post-cutoff date arrears is formally resolved, Russia would be prepared to deliver its part of the HIPC Initiative assistance to Madagascar on a par with other Paris Club creditors.

We understand that the papers for today's discussion will be published. Thus, we would like to point at some technical mistakes in EBD/00/106 on pages 3 and 4. Footnotes 6 and 7 should be deleted as they repeat footnotes 3 and 4, respectively.

With these remarks we wish the authorities well.

Mr. Yoshimura and Mr. Harada submitted the following statement:

Notwithstanding the heavy damage inflicted by the three cyclones that hit the area in the beginning of 2000, Madagascar's economy is expected to improve, with growth estimated to reach 4.8 percent this year. In the previous review for the PRGF, fulfillment of the quantitative performance criteria for end-June was reported to the Board. ESAF/PRGF programs going back to as early as 1996 have - apart from the slippage in 1998, which was due to political reasons - stayed broadly on course. In recent years, the fiscal and monetary position has improved and inflation has been subdued. Overall, the authorities should be commended for their efforts. We believe Madagascar has a sufficient track record for reaching the decision point and we concur with the staff's proposal to have Madagascar reach the decision point.

A number of tasks remain, however, such as implementing the VAT refund, strengthening revenue collection and administration, and allocating adequate funds to the social sector. Fundamental soundness of the fiscal situation is an integral aspect of the effective and efficient use of the funds made available by the HIPC initiative. Structural issues such as progress in decentralization and privatization as well as improvement in implementation capacity through Civil Service Reform are important elements in addressing the proper use of funds in accordance with demands, and they are areas on which we have some concern.

From this standpoint, in the preliminary discussion on November 11 several Directors questioned Madagascar's reaching the decision point before the end of the year in the absence of a medium-term economic program under a new PRGF. But since staff and the authorities had almost reached agreement on the outline of the economic program and since performance under the previous PRGF program had been good, allowing one to rationally expect that the funds freed from HIPC assistance would be used effectively, the Board,

including myself, supported the possibility of Madagascar's reaching the DP before the end of the year.

In discussing Madagascar's eligibility to reach the DP, we would like to comment on the following points, which we believe are important in the short to medium term.

As a means to increase revenue, measures such as the recruitment and training of tax customs inspectors, the restructuring of the tax and customs administration, and reinforcement of the system of revenue monitoring and control have been mentioned. We would like to know what progress has been made in these areas so far and what concrete actions will be taken next year.

On expenditure management, enforcement by the national auditing office (IGE) and increasing the number of judges in the national audit court to recruit 34 national auditors seem to be actions in the right direction.

On the structural side, privatization is important not only for revitalizing the private sector, but also because of its fiscal financing aspect. Other crucial issues are rural development and land right security with necessary judicial reform.

On decentralization, the paper notes that the election of provincial councils will take place in December, and that the power of local offices will increase together with their accountability to the provincial councils. Decentralization is effective in enabling the public service to meet the needs of rural areas, and since reducing poverty in rural areas is a matter of urgency, decentralization would seem to be a valid policy measure. On the other hand, decentralization increases the importance of expenditure management. In the Board discussion on Niger, it was explained that decentralization had hindered the central government's imposition of revenue enhancement policies. Madagascar still does not have enough capacity for stable revenue collection. How to coordinate the policies of decentralization and revenue enhancement is of vital importance, and we would urge the authorities to exercise caution in this area.

On the floating completion point triggers, we think that overall they are well balanced. Especially on the issues of governance and strengthening of budget procedures and administration, the triggers are properly detailed. However, we noticed that the social sector was described much less fully than in the Preliminary Document. Although it may not be appropriate to include too many results-oriented triggers in light of the authorities' limited policy implementation capacity, we feel that the issue of the national AIDS awareness campaign should have been included in the description of the social sector. While it is true that the incidence of AIDS is not as high in Madagascar as on the African mainland, the fact that AIDS is spreading so rapidly in

Africa makes it significant that preventive measures are being taken by Madagascar.

On the issue of how the funds freed by the HIPC initiative are to be used, paragraph 67 of the staff report mentions that a supplementary budget including the use of such funds will be considered in line with the discussion on the year 2001 budget, and we commend the authorities' commitment to this matter. The staff report also mentions that for 2002 how such funds will be used will be included in the regular budget. We hope the authorities will take care to use the freed funds effectively.

On the I-PRSP, we commend the authorities for having made the best effort within their limited capacity. We concur with staff that the areas the authorities need to work on are refining data on poverty, setting concrete poverty reduction targets, revising the too optimistic macro economic projections, assessing the cost of these strategies and connecting them to the annual budget or mid-term programs. Given the necessary participatory process, the authorities' schedule to prepare and submit a full PRSP to the donors by mid-2001 seems rather ambitious. We hope they will take sufficient time to assure a proper participatory process to refine the paper.

Mr. Milleron and Mrs. Boucher submitted the following statement:

We commend the Malagasy authorities for the significant progress made since 1996. The structural reforms which have been undertaken by the government in a number of key areas, including the financial sector, have borne their fruits, restored investors' confidence and translated into higher investment rates. However, the greatest challenge for Madagascar remains to increase significantly and sustain in the long term a high growth rate pattern in order to fight against pervasive poverty.

The authorities managed to produce the I-PRSP through a commendable participatory process as assessed by staff and we believe it provides a good basis for the elaboration of the full PRSP. We welcome the fact that an agreement has been reached between the Malagasy authorities and staff on a program of economic and structural adjustment which is consistent with the I-PRSP, as underlined by Mr. Barro Chambrier in his very helpful Buff. Therefore, although we think it would have been preferable to better coordinate the timing of the decision point document discussion with the conclusion of the new PRGF arrangement, we can agree that Madagascar has reached its decision point and with the provision of interim assistance as proposed.

Turning to the I-PRSP, we share the views expressed by staff that the growth assumptions underlying the baseline scenario are probably too optimistic and that a rate of 4-5 percent in line with the past three year average

growth would have made more sense. Indeed, even though Madagascar is blessed with valuable resources, particularly in the fishery, mining and tourism sectors, the country remains highly vulnerable to exogenous factors, including climatic hazards which strongly hit the country earlier this year.

While preparing the full PRSP, we encourage the authorities to better prioritize the objectives of the program to allow adequate allocation of resources according to the expected outcome in terms of poverty alleviation. We welcome the innovative mechanism which is proposed to allow for an efficient use of significant resources which will be delivered through the HIPC initiative. But, efforts to strengthen global budget monitoring and control will remain crucial, especially given the fact that the decentralization process will need to be enhanced to facilitate expenditure management at the local levels.

Finally, we can confirm that the Paris Club creditors have agreed in principle on the assistance to be provided under the HIPC initiative. However, the figures on debt relief mentioned in the staff report are only preliminary and require further reconciliation work. France will grant a 100 percent debt relief on pre-cutoff date commercial debt. Interim assistance to be delivered by the Paris Club creditors is likely to be granted on Cologne terms but will be subject, as usual, to prior approval of the PRGF program by the IMF Board.

Mr. Mirakhor and Mr. Rouai submitted the following statement:

I would like to commend staff for the set of comprehensive and balanced papers, and Mr. Barro Chambrier for his helpful statement.

I welcome the interim PRSP prepared by the Malagasy authorities, which outlines a comprehensive poverty reduction strategy for a country where about 70 percent of the population live below the poverty line. The authorities should be commended for their efforts in preparing this interim PRSP, which constitutes a major step in implementing a comprehensive poverty reduction strategy in Madagascar, and should be encouraged to consolidate this work into a final PRSP with the required technical assistance and the necessary resources in a timely manner. I note with satisfaction that the interim PRSP has benefited from broad consultations and extensive discussions with the private sector, representatives of donors, government officials, and a large number of civic organizations.

I am reassured by the staff's assessment that the components of the poverty reduction strategy are realistic and that they emphasize the appropriate areas. I am also pleased to note from Mr. Barro Chambrier's statement that the authorities will address the concerns raised by staff regarding the need to incorporate the views of the poor in the full PRSP. I encourage them to prioritize public interventions aimed at reducing rural

poverty and to carefully phase transfer of responsibilities and financial resources to the local level.

On the HIPC initiative, I confirm our support for Madagascar's eligibility to debt relief under the enhanced HIPC initiative on the basis of the DSA and the country's overall track record since 1996. We also support staff's and management's recommendation on the decision point.

Turning to the triggers for reaching the completion point, I thank the staff for their efforts since the preliminary HIPC document to better prioritize the triggers and to explain their rationale. The list of preconditions remains long, and I hope that the authorities will develop, with the support of the World Bank and the Fund, the required administrative capacity to implement them. In this context, I look forward to the next PRGF arrangement.

Mr. Wei submitted the following statement:

At the outset, let me thank the staff for the well-prepared set of papers and Mr. Barro Chambrier for his very helpful statement. We are stunned by Madagascar's heavy external debt burden and its widespread and deep poverty, making it one of the poorest countries in the world. However, we are encouraged by the authorities' commitment to embark on a comprehensive program to fight poverty through the promotion of economic growth and the better allocation of fiscal resources. The program is ambitious in many aspects. However, we agree with others that it is achievable. We fully support the authorities' policy measures included in the program, support staff and management's recommendation that Madagascar be eligible for relief under the Enhanced HIPC Initiative, and agree that it has reached the decision point. We also broadly agree with staff's and management's recommendation for a floating completion point, to be reached when the conditions outlined in Box 8 are met. As we are in broad agreement with the staff appraisal and share many of the views expressed in Directors' grays, I will limit myself to a few areas for emphasis.

First, we are pleased with the authorities' implementation record under Fund-supported programs, particularly with the recently approved PRGF. Economic growth has been relatively stable and inflation has been reduced significantly compared with pre-1997 levels. However, many challenges lie ahead for the authorities - in particular, improving the fiscal situation and carrying out structural reforms. We support the authorities' poverty reduction strategy through implementation of a new generation of reforms focusing on pro-poor growth and institutional development. We support the economic objectives outlined in paragraph 25 of the paper. In this regard, the importance for the authorities to implement sound macroeconomic policies cannot be overemphasized.

Second, on fiscal policy, as noted in the paper, the tax revenue ratio to GDP has been at low levels compared with many other developing countries. Therefore, we support the authorities' intention to increase tax revenue from 12 percent of GDP in 2000 to about 13 percent in 2003, mainly through improved tax administration. In this regard, we believe the technical assistance provided by the Fund and other international institutions is very important, aiming at training tax officials and strengthening the capacity of tax administration agencies. We are also concerned about the impact on the fiscal account if an economic growth rate of 6 percent could not be achieved as a result of unexpected changes in the external environment. Staff comments would be appreciated.

Third, on the issue of the environment - Madagascar's most treasured asset in terms of attracting tourism - while we are encouraged by the policy measures included in the program to protect the environment, we are concerned about the degradation and seriousness of the environment as highlighted in Box 5. The country has already lost 80 percent of its original forest cover, more than half in the past 40 years. One of the completion triggers is the open and transparent license distribution for logging which is the first important step in assessing the pace and impact of commercial logging. It is our view that more measures are needed to preserve the forests - so important for the livelihood of the rural poor.

Fourth, on the issue of allocating more resources for social expenditure, it is indeed welcome that this has been emphasized in the program as elaborated in Table 6. However, we notice that social spending, including HIPC financed expenditures, will be increased from 5.1 percent of GDP to 6.7 percent of GDP, which is only a 0.5 percent increase compared with the pre-HIPC assistance figure. Given the urgent need to improve education and health, it seems to us that more expenditure in these areas is called for. Staff comments would be appreciated.

Finally, we agree that Bank and Fund staffs should continue working toward securing the participation of other multilateral creditors.

We wish the authorities every success in their strategy to alleviate poverty through achieving sustainable economic growth.

Mr. Kelkar made the following statement:

At the outset, we are grateful to the staff for a set of comprehensive papers as well as Mr. Barro Chambrier for his insightful buff. We are in broad agreement with the staff proposals and therefore would like focus on a few issues only.

We commend the participatory process through which the I-PRSP was formulated and are encouraged by the efforts of the authorities to undertake a similar consultative process for the preparation of the PRSP. However, looking at page 40 of the I-PRSP, and Page 2 of the joint Staff Assessment, we are still not clear what the exact role of the democratically elected institutions was in its preparation vis-à-vis the other participants in the consultation process. Staff point out that only 4 percent of the persons who attended the second consultation were mayors and parliamentarians. This seems hardly representative. Given the diversity of voices inherent in any wide consultation process, who will have the final say in the preparation of the PRSP? Will it be the democratically elected institutions at the Central and provincial level? How is this built into the modalities of the consultation process—detailed in Appendix 7 of the I-PRSP? Staff have pointed out in Para 23 of the joint assessment that the National Assembly will have to approve the supplementary budget for allocating the interim debt relief. But it is not clear whether the PRSP per se will also be approved by them. We welcome staff comments.

The candid assessment of the country's past economic performance detailed in the I-PRSP is impressive. The I-PRSP also highlights the relatively greater prevalence of poverty in the rural areas when compared to the urban areas, in some provinces when compared to others and the disadvantage women suffer . While we agree that the three pronged initiative outlined in the paper is a good starting point for poverty alleviation efforts, it does not appear that the I-PRSP consciously attempts to correct for the skewed ness in the three areas outlined above-through specifically focused efforts. We therefore agree with staff comments that PRSP should 'prioritize public interventions aimed at reducing rural poverty' and would like to see such differentiated efforts extended to poorer provinces as well as women in the PRSP.

During the last review, we had expressed concern about the scope and range of the proposed decentralization initiative with respect to essential social services. We are therefore encouraged by the statement in Mr. Barro Chambrier's buff that the Government proposes to transfer responsibility for delivery of local services such as roads, primary health and education to the provinces. We presume this includes responsibilities such as recruitment, and would be accompanied by suitable revenue transfers to the provinces through either devolution or the ability to raise the finances . We would have been happier if a suitable time frame had been indicated for this. Staff have, in the decision point document, mentioned a period of eighteen months for the transfer of responsibilities to the provinces, but this subject has been discussed on Page 35 of the I-PRSP in general terms only. We look forward to seeing this in greater detail in the final PRSP.

We commend the detailed consultation with the donors which formed part of the participatory process in the preparation of the I-PRSP. Staff have also outlined the assistance to be provided by the donors during the preparation of the full PRSP. Given the high level of coordination which has been achieved between donors, and their ownership of the objectives of the PRSP, its implementation would be more effective if donors channel their assistance through the Malagasy budget, rather than by financing individual programs. We are no clear whether this is on the agenda and would welcome staff comments.

We agree broadly with the completion point triggers outlined in Box 8 of the decision point document. However, it is not clear whether the financial monitoring and control systems are sought to be put in place, are confined to the operations of the Central Government . To ensure that the decentralization initiative will not lose its momentum, we presume that a similar effort will be made in the provincial governments also. We are also not very comfortable with the inclusion of output oriented targets in the completion point triggers. We appreciate the staff point that the time period available till the completion point is reached is too short for a measurable impact on outcome indicators (for which, in any case, no base line exists) to occur . However, we are concerned that these output indicators may be perceived as attempts at micro-management and serve to dampen any initiative to change them in the light of local conditions. For e.g. the stipulation that at least 10 percent of the Road Maintenance Funds should be spent on rural roads may possibly serve as an upper bound in an agriculture oriented economy, which clearly needs to develop its rural infrastructure as fast as possible. Staff comments are welcome.

We are concerned about the lack of agreement with the non Paris Club creditors on the need for them to provide treatment consistent with the Paris Club creditors. Given that the amount involved is less than 10 percent of the total package, we presume this will not delay implementation of the initiative.

Having said this, we agree with staff that the I-PRSP is a sound basis for developing a PRSP as well as reaching a decision point under the HIPC initiative and for Fund concessional assistance. We also agree with the recommendations in Para 70 of the decision point document.

We wish the authorities all success in their policy endeavors.

The staff representative from the African Department noted that there were still outstanding issues related to debt reconciliation, in particular concerning bilateral claims of Paris Club members. However, the staff expected those issues to be resolved soon. To take into account those outstanding claims, the staff had suggested that the Board approve a lightly lower amount of interim assistance. Accordingly, interim assistance for Madagascar would amount to $21.6 million rather than $22.1 million, as had been indicated in the

decision point document. Once the staff had reconciled the data for the entire stock of outstanding debt, a revised decision would be circulated for approval on a lapse-of-time basis. The proposed revision would not affect the first installment of IMF interim assistance.

Ms. Redifer made the following statement:

We have no difficulty supporting today's decision. The IPRSP reflects an extensive and fairly well-developed strategy that has already involved considerable public participation. We were especially pleased to see the detail provided on the use of resources provided by HIPC interim relief, the monitoring mechanisms planned, and the completion point trigger that will verify the use of resources as planned. We are hopeful that public participation continues to be strong in the monitoring of uses of interim relief. The approach outlined, as well as that of Cameroon, which we will discuss in the next meeting, seem to us to be good examples of how interim relief should be handled. We generally concur with the joint staff assessment of the IPRSP and the proposed structure for delivering relief, but I would like to make a few points.

First, we share the view expressed in many of the written statements and in the joint staff assessment that the underlying growth rate assumed by the DSA may be too high, even if investment increases as planned. Let me emphasize that there is no mechanism in the HIPC Trust Instrument for adjusting the amount of assistance upward if it turns out that the underlying assumptions determining the level of assistance were incorrect.

In developing the full PRSP, the authorities should consider a few points. While the IPRSP reflects an ambitious reform agenda and may need more prioritization, there needs to be more attention paid to environmental issues. These are extremely important for sustainable development in Madagascar, partly due to its unique biodiversity. A main issue in biodiversity conservation is halting deforestation from shifting slash and burn agriculture. Similarly, there is a need for regulation to discipline the boom in gem stone mining.

More attention also needs to be given to rural and agriculture development, and supporting infrastructure, such as roads, power and telecommunications. According to the U.S. Agency for International Development mission in Madagascar, there are a number of possibilities, for example, micro finance schemes for farmers and development of market information systems, to keep farmers appraised on product types, prices quantities and qualities desired on the domestic and international market.

Incorporation of these elements and further refinement of the full PRSP will take time. We encourage the authorities to take as much time

needed to develop a strong and coherent poverty reduction and growth strategy that can serve the country well for many years.

To conclude, I would like to say we will also be looking for a more specific description in the next PRGF review on how the growth and social objectives of the poverty reduction strategy are being integrated into the design, sequencing and pace of the macroeconomic adjustment program.

Mr. Al-Turki made the following statement:

I am encouraged by Madagascar's progress in adjusting and reforming its economy. The fiscal improvements and structural reforms have paid off in improved growth and higher reserves. The authorities are to be commended for this performance which was achieved despite the damage caused by the three cyclones that hit the country. This progress notwithstanding, faster and more broad-based growth is critical to pull the country from its present status as one of the world's poorest countries. That said, it is also important to ensure that the growth targets are realistic in the context of the difficulties confronting Madagascar.

I share the joint staff assessment that the I-PRSP comprises a major step forward in process and content toward a full PRSP. I am encouraged particularly by the authorities' ambitious program to strengthen the institutional structure and improve delivery of basic services. In this connection, focus on upgrading the rural infrastructure, including the transport system, is a priority in view of the concentration of some 75 percent of the population in isolated rural enclaves. Notably, the authorities have laid out the strategy within a well-specified medium-term macroeconomic framework.

Given the progress already made, I welcome staff's suggestion to relax the time-line for the authorities to ensure a high quality PRSP. Let me stress here that such flexibility should be the rule in other comparable cases. Indeed, as the joint staff assessment paper points out, in considering the choice between the speed and the quality of a PRSP, it is generally true that "proper reflection and discussion should have precedence over adhering to the tight time schedule … "

Turning to the issues for discussion, I agree with the staff's assessment that Madagascar is eligible for assistance under the enhanced HIPC Initiative. I also agree to the proposed decision point and provision of interim assistance. Regarding the completion point, I agree with the triggers in Box 8. Here, the importance of technical assistance cannot be overemphasized.

With these remarks, I support the proposed decisions subject the understanding mentioned by the staff and wish the authorities success.

Mr. Sdralevich made the following statement:

We support Madagascar's decision point and welcome the Interim PRSP. We are glad to read from Mr. Barro Chambrier's helpful Buff statement that an agreement on the PRGF has been reached. The program will be an indispensable basis both for the track record underlying the HIPC initiative, and for the poverty strategy itself.

We welcome the Interim PRSP and we particularly commend the thoroughness of the completion point triggers. Overall, we agree with the staff's comments, particularly in the well balanced joint assessment of the Interim PRSP. We also agree with many of the comments made by other Chairs, in particular on the vulnerability of the economy. We also join Mr. Wei in calling attention to environmental problems. Also in light of the accelerated procedures, let me make just a few brief remarks.

First, the development of a poverty monitoring system is essential. While we commend the authorities for the steps taken, we agree with the staff that it should be in place by the time the full PRSP is completed, since this is an crucial element of the poverty strategy.

Second, we urge the authorities not to underestimate the HIV/AIDS threat. The spread of the disease is still limited in Madagascar, and the authorities should fully exploit this advantage. The costs and the difficulty of holding the contagion in check will increase exponentially with time.

Third, we are worried by the ongoing fiscal decentralization process. Even though, in itself, decentralization can be highly desirable, there are great risks arising from the lack of accounting and expenditure controls at the local level as well as serious deficiencies in institutional capacity. Ultimately, these problems can have a very serious impact on the success of the poverty strategy.

With these remarks we wish the authorities continued success.

Mr. Pickford made the following statement:

I would also like to join others in agreeing that Madagascar is eligible for the decision point and should receive interim relief. I have just a couple of comments on the decision point issue.

In terms of the debt sustainability analysis, the sensitivity analysis should take into account the fact that Madagascar is subject to climactic shocks. Also, I note that new debt rises quite quickly in the new projection. It is therefore important that the government develop a comprehensive debt strategy. I welcome the detailed description of the use of HIPC funds. This is

rightly subject to the approval of parliament, but I also support the other proposed measures for tracking HIPC funds.

The completion point triggers are generally appropriate. Although somewhat numerous, they identify key priorities from the government's poverty reduction plan. I have a slight difficulty with the precision of trigger two, however. If taken at face value, it implies that the use of budgetary savings will be determined entirely by whether they meet the figures set out table 2. These should rather be considered as a preliminary indicative use of the HIPC funds.

On the I-PRSP, it seems to me that the government has made a strong commitment to tackle poverty by setting up detailed targets. Achieving these will require a major effort on the government's part. In that regard, I welcome the fact that a number of bilateral donors provide assistance in support of the PRSP priorities, including through budgetary support.

I would encourage the government to ensure that all stakeholders are included in the development of the full PRSP, including the poor. Furthermore, more work is needed to ensure full costing of the measures. I agree with Ms. Redifer on the need to stress the environment of Madagascar, and the government must therefore ensure the final PRSP incorporates principles of sustainable development.

Poverty is pervasive in rural areas. Identifying measures to tackle rural poverty will be central for the government as it completes the full PRSP, and it should do its utmost to ensure a comprehensive participatory consultation of the poor.

The staff representative from the African Department stated that at present only 1 percent of available infrastructure maintenance funds were being spent on improving rural roads. Given the importance of agriculture, the staff had included a completion trigger that would increase spending on rural roads by 10 percent.

Budgetary reallocations to the education and health sectors would increase by more than 1 percent of GDP over the next 2-3 years, from 5.1 percent of GDP to 6.7 percent of GDP, the staff representative continued. While that increase was relatively modest, there were other sectors in the economy that would also benefit from HIPC resources, including rural infrastructure and water and sanitation. According to World Bank staff, structural reforms were needed urgently in health and education in order to improve the delivery of services.

Environmental issues had been included in the I-PRSP and would receive further attention in the full PRSP, the staff representative remarked.

It was difficult to forecast the effect of important exogenous shocks, the staff representative related. In the case of Madagascar, export growth had in recent years been more dependent on the manufacturing sector - especially textiles - than on agriculture.

The authorities were planning a number of additional participatory sessions which would include elected officials from the provinces to discuss the PRSP, the staff representative said. Discussion of the poverty reduction strategy would continue even after the PRSP had been finalized.

The staff representative from the World Bank noted that Madagascar would receive a total of $60 million in debt relief. However, even if the authorities decided to channel all those resources into education and health, expenditures in those sectors would increase by less than 50 percent. However, the staff had encouraged greater focus on those two areas through the formulation of completion point triggers. For instance, one trigger focused on creating incentives for teachers to take up positions in rural areas; the student-teacher ratio in rural areas was much higher than in urban areas because of the lack of such incentives. A key constraint in the health sector was the cost of drugs, which absorbed a high percentage of some poor families' expenditures. A higher allocation of resources to primary healthcare centers would help expand the availability of generic drugs, and had therefore also been included in the HIPC framework as a completion point trigger.

Land distribution was a contentious issue in Madagascar, the staff representative continued. The population attached great importance to the ownership of land, and there was therefore resistance to selling. The staff had therefore emphasized land rental and access to rural credit as a means to increase mobility in its policy dialogue with the authorities. Agriculture in Madagascar was low-yielding and dependent upon irrigation rights, which were even more unequally distributed than the land itself. IDA and the World Bank had undertaken two large projects that would improve access to small scale irrigation, thereby increasing yields and reducing poverty in the rural areas.

The staff representative from the African Department said that both Fund and Bank staff expected the authorities to be able to meet all the completion point triggers. While some of the conditions outlined in box 8 of the staff report were quite detailed, the staff had decided that detailed outcome triggers would be useful, especially in the areas of education and health.

Almost all external aid flows were accounted for in the budget through public investment programs, the staff representative said.

Mr. Elkjær made the following statement:

> I want to make only two points. First, I said at the time of the discussion of the preliminary HIPC Decision Point Document that I would have preferred to have a decision point and Board approval of the PRGF-supported arrangement at the same time. I am glad to hear from Mr. Barro Chambrier that the question of the PRGF-supported program has been settled.

I can therefore agree to the proposed decision. Second, I fully agree with the staff that the PRSP should not be finalized too quickly. Speed must not be allowed to compromise quality.

Mr. Siegenthaler made the following statement:

For a change, this Chair will be brief in this HIPC marathon. We very much welcome the progress that has been made on the new PRGF arrangement. As I understand, a Draft LOI already exists. Of course, like Mr. Elkjær (Nordic Chair) we would have strongly preferred to approve both the HIPC decision point and the new arrangement at the same time. But the real world – or the real world HIPC Initiative – is obviously not always ideal and we can thus support the early decision point.

We commend the authorities for having met all quantitative performance criteria for end-June 2000 as well as all quantitative benchmarks for end-September 2000 under the second annual PRGF arrangement. The country has thus an uninterrupted and fairly sound track record of some one year and a half. Measured by our subsequently lowered threshold of what is a sufficient track record, Madagascar therefore quite clearly meets the requirements for the approval of the decision point.

Mr. Yepez made the following statement:

Madagascar's economic performance under the PRGF-supported arrangement has been encouraging, despite the adverse impact of the cyclones that hit the country at beginning of the year. All the program's quantitative performance criteria were observed by a significant margin, as were the structural performance benchmarks. The commitment of the authorities to the program allowed inflation to remain under control and economic growth to reach 4.8 percent of GDP despite adverse weather conditions. The authorities have shown strong commitment to improving macroeconomic policies and have been undertaking a number of structural reforms, including a comprehensive program of privatization.

We agree that Madagascar is eligible for support under the enhanced HIPC Initiative and support the proposed timing of the decision point. We share the staff's assessment that the measures outlined in the I-PRSP will help achieve sustained growth and poverty reduction. The completion point triggers outlined in box 8 of the staff report show that the authorities have assumed ownership of the I-PRSP process.

Finally, we welcome the initiative to develop a set of monetary indicators that will follow the implementation of the poverty reduction plan. We agree with the staff's proposal to continue reviewing Madagascar's debt sustainability data even after the delivery of debt relief so as to adjust for

possible exogenous shocks. We wish the Malagasy authorities well in their endeavors.

Mr. Jacoby made the following statement:

I will be brief. We agree with the proposed decision. We share the concerns expressed by Mr. Sdralevich regarding the monitoring system and the risks associated with decentralization. The authorities must ensure that expenditure controls remain effective at all levels of government so as to prevent fiscal slippages.

Mr. Vogel made the following statement:

I agree that Madagascar is eligible for debt relief under the enhanced HIPC Initiative. I support the proposal to deliver interim assistance and the conditions for reaching the floating completion point set out in box 8 of the staff report. The problems encountered by the staff in reconciling Madagascar's data on external debt underscores the need for comprehensive technical assistance. We wish the authorities every success in their endeavors to create conditions for sustained economic growth and poverty reduction.

Mr. von Kleist made the following statement:

Since I agree with the thrust of staff's appraisal and most of the points made by previous speakers, especially Ms. Redifer and Mr. Sdralevich, I shall only make a brief remark. I consider Madagascar's track record to be satisfactory, despite its low revenue-to-GDP ratio. The debt problems are a direct result of the failure to raise enough domestic resources to meet domestic needs. A decisive broadening of the revenue base and improvements to the still weak budgetary process will have to play an important role in the efforts to reach a sustainable debt situation and create a path of economic development that will improve the conditions of the poor.

Mr. Wei wondered whether the authorities had developed contingency measures in the event that the projected growth rate of 6 percent of GDP per year failed to materialize. The social sector expenditure ratio would increase by only 3.5 percent per year, which appeared somewhat low, given the amount of resources that would freed up through debt relief.

The staff representative from the African Department noted that even though the revenue-to-GDP remained low, it had increased from 8 percent of GDP in 1997 to 11 percent of GDP in 2000. The authorities had for instance strengthened the collection of value-added tax and introduced a unified income tax for small businesses. However, revenues had declined somewhat following the phasing out of custom revenues arising from trade with Mauritania. Decentralization might assist in improving the revenue base, as local authorities

might be more successful in collecting taxes from local businesses than the central government.

Foreign aid provided a buffer in the event of exogenous shocks, the staff representative said.

Debt relief under the HIPC Initiative would lead to an increase in social expenditures from 4.8 percent in 2000 to 6.2 percent in 2003, the staff representative said. While that increase was not very large, HIPC relief amounted only to approximately 1 percent of GDP. Furthermore, other priorities—such as improving rural infrastructure—were equally important in helping to reduce poverty, as more roads would improve access for agricultural products to local markets. Water supply must also be improved. Decentralization might also help improve the provision of services to the poor.

The staff representative from the World Bank stated that the authorities were planning to use 4 percent of HIPC interim debt relief funds to develop a poverty monitoring system, which would be based in part on a household survey planned for 2001. Such a survey would complement other surveys that had been completed recently in the areas of demography, health, education, and welfare. Multilateral and bilateral donors were providing support in that process, and the staff was confident that a sound monitoring system would be in place by the time of the completion of the full PRSP.

Mr. Barro Chambrier noted that the authorities had already made good progress on a number of structural reforms, especially in the area of privatization and improvement of the regulatory framework. Those reforms would contribute to economic growth. However, in order to succeed fully, Madagascar would need further external assistance, not only in the form of concessional flows from donors and bilateral creditors, but also from private investors. As part of their reforms, the authorities would also seek to improve transparency and accountability, broaden the tax base further, and strengthen budget management.

Interim assistance under the HIPC Initiative would help improve the delivery of services to rural areas and upgrade rural infrastructure, Mr. Barro Chambrier concluded. The authorities were looking forward to receiving technical assistance from the Fund and the World Bank on the issue of decentralization, so as to ensure fiscal stability and a sound use of resources.

The Acting Chairman made the following summing up:

> Directors welcomed the government's interim PRSP and considered that it constitutes a sound basis for the preparation of a full PRSP. They commended the authorities on their participatory process and encouraged them to strengthen further the consultative approach, with a view to including the poor and most vulnerable groups of society more fully in the participatory process. Directors agreed with the authorities that poverty reduction will require policies to sustain economic growth, expand income-generating activities for the poor, and improve health and education and other essential

services. They stressed the importance of ensuring that environmental concerns are properly incorporated in the PRSP. Directors welcomed the government's objective of completing a full PRSP by mid-2001, but noted that much remains to be done in order to ensure that the PRSP is based on realistic economic assumptions; reflects sufficient prioritization among the various objectives; and includes full costing of the programs intended to achieve these objectives.

Madagascar is a PRGF-eligible and IDA-only country, and its external debt burden is unsustainable, even after taking into account relief provided under traditional debt relief mechanisms. Directors agreed that Madagascar has established a credible track record of good performance in the context of IMF- and World Bank-supported adjustment and structural reform programs, and that it therefore has reached the decision point under the enhanced HIPC Initiative. Some Directors would have preferred this decision to be taken once Madagascar has reached an agreement with the Fund on a medium-term economic program to be supported by a new PRGF-arrangement.

Directors agreed that Madagascar could reach the floating completion point when the conditions contained in Box 8 of the HIPC Decision Point Document are satisfactorily implemented (EBS/00/251). A few Directors would, however, have preferred a stronger concentration on the triggers that are of critical importance for assessing policy progress. Directors welcomed the agreement on a comprehensive set of indicators to monitor the implementation of the government's program.

Directors emphasized the importance of ensuring that the budget resources released by debt relief are used for the priority action programs that are directed at poverty reduction. They welcomed the authorities' intention to monitor the utilization of these resources with appropriate mechanisms. In this context, Directors attached importance to the commitment by the authorities to strengthen the procedures for improved monitoring and reporting of government budget execution; this will be essential to improve transparency and strengthen oversight of the use of public resources. They urged the authorities to implement their strategies in the health and education sectors with determination, and to improve the delivery of basic social services, as a key element of the fight against poverty.

Directors welcomed the Malagasy authorities' commitment to continue their adjustment efforts, and looked forward to a medium-term program that could be supported by a new three-year arrangement under the PRGF. It was also suggested that Madagascar's debt sustainability be kept under regular review, given the high vulnerability of its export base to exogenous shocks.

The Executive Board took the following decision:

1. Based upon the external debt sustainability analysis for Madagascar (EBS/00/251, 12/5/00), the Fund as Trustee (the "Trustee") of the Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations (the "Trust"), established by Decision No. 11436-(97/10), February 4, 1997, decides that:

(i) in accordance with Section III, paragraphs 1 and 2 of the Trust Instrument (the "Instrument"), Madagascar is eligible and qualifies for assistance under the enhanced HIPC Initiative as defined in the Instrument;

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

(a) Madagascar has satisfactorily implemented the policy reforms described in Box 8 of Madagascar's decision point document under the enhanced HIPC Initiative (EBS/00/251, 12/5/00),

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

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

(iii) the external debt sustainability target for Madagascar is 150 percent for the present value of debt-to-exports ratio;

(iv) in accordance with Section III, paragraph 3(a) and 3(b) of the Instrument, the equivalent of SDR 16.60 million of assistance shall be made available by the Trustee to Madagascar in the form of a grant to permit a further reduction in the net present value of the debt owed by Madagascar to the Fund;

(v) in connection with the interim assistance contemplated under Section III, paragraph 3(d) of the Instrument,

(a) satisfactory assurances have been received regarding the exceptional assistance to be provided under the enhanced HIPC Initiative by Madagascar's other creditors, and

(b) the Trustee shall disburse to Madagascar as interim assistance the equivalent of SDR 0.6774 million no later than three business days after the adoption of this decision to an account for the benefit of Madagascar established and administered by the Trustee in accordance with Section III, paragraph 5 of the Instrument; and the proceeds of the grant shall be used by the Trustee to meet Madagascar's

debt service payments on its existing debt to the Fund in accordance with the following schedule: 53.3 percent of each repayment obligation falling due until December 31, 2001.

(vi) in accordance with Section III, paragraph 3(e) of the Instrument, the Trustee shall disburse the remainder of the assistance committed to Madagascar under paragraph (iv) of this decision at the completion point, together with interest on amounts committed but not disbursed during the interim period, calculated at the average rate of return per annum on investment of resources held by or for the benefit of the Trust.

2. The Fund has reviewed the Interim Poverty Reduction Strategy Paper submitted by Madagascar and concludes that it provides a sound basis for the development of a fully participatory PRSP, for reaching the decision point under the HIPC Initiative, and for Fund concessional assistance. (EBS/00/251, 12/5/00)

Decision No. 12380-(00/129), adopted
December 21, 2000

4. CAMEROON—POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT

The Executive Directors considered a staff paper on Cameroon's request for a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) (EBS/00/255, 12/6/00; Cor. 1, 12/19/00; and Sup. 1, 12/20/00).

Mr. Barro Chambrier submitted the following statement:

Introduction

Cameroon's economic performance remains good after the successful completion of its first three-year PRGF program and the reaching of the decision point under the HIPC initiative. Government's commitment to reforms has resulted in substantial improvements in economic and financial conditions, including the strengthening of public finance, rehabilitation of the domestic banking system, normalization of relations with external official creditors, launching of an ambitious privatization program, and progress in governance and transparency issues. However, the economic situation remains fragile as investment and growth are still hindered by structural rigidities, high transaction costs, cumbersome administrative procedures, and the need to further advance on governance issues. Building on the achievements under the previous PRGF, and consistent with the objectives of the I-PRSP, the new three-year program under the PRGF for the period October1, 2000-September 30, 2003, for which my authorities are seeking the support of the Board will consolidate macroeconomic gains, while implementing second generation of reforms in areas that will have a lasting impact on poverty.

Although the success of the program rests primarily with the Government, it also depends on the timely availability of resources from the international community. This highlights the need to reach a comprehensive debt rescheduling agreement with the Paris club during the ongoing round of negotiations.

Background and Recent Development

During the first three-years the PRGF-supported program, Cameroon established a good track record of policy implementation. Real GDP growth averaged 4.5 percent. Inflation was contained at about 1 percent. The external current account deficit (including grants) narrowed from 4.1 percent in 1998-1999 to 1.4 percent in 1999-2000. These results were achieved, thanks to sound policies and buoyant oil prices.

On the fiscal front, my authorities took action to strengthen revenue collection in both oil and non-oil sectors, while revamping the weak expenditure management system. Prudent fiscal policy helped the authorities to normalize relations with creditors through clearing all external arrears and devising an action plan to clear domestic arrears.

On the structural front, large-scale privatization was launched in the telecommunications, water, electricity and agro-industries. Significant actions were also taken to liberalize the transport and energy sectors as well as improve road maintenance and launch the restructuring of the port of Douala. Structural reforms were complemented with incentives policies to eliminate non-forestry export taxes, remove the monopoly of the national oil refinery company (SONARA), and liberalize the refined petroleum prices.

Successful economic policies gave a new momentum to reforms and provided a framework for improving social conditions. The authorities adopted sectoral strategies in education and health, (including a campaign for HIV/AIDS), which constitute the basis for the I-PRSP. An encouraging start was made in improving governance with the adoption of a governance and anti-corruption strategy, operational and financial audits of the national oil company (SNH), and the reform of the public procurement code.

Medium-term Program for 2001-03

The medium-term policy framework rightly focuses on consolidating the gains achieved under the previous PRGF program in the budgetary and structural areas while improving governance, the judicial system and basic infrastructure, so as to set the conditions for sustained growth. My authorities expect real GDP to increase from 5.4 percent in 2000/01 to 6.1 percent in 2003/04. Sustained economic growth, together with social policies

envisaged in the I-PRSP, are expected to provide tangible poverty reduction results to a large portion of the population.

Policies for 2000-01

Consistent with the medium-term objectives, the macroeconomic objectives for the first year (October 1, 2000-September 2001) of the program supported by the PRGF are as follows: GDP is expected to reach 5.4 percent in 2000/01. Inflation would be contained at 2 percent and the external current account (excluding grants) would be limited at about 3 percent of GDP in 2000/01. To attain these objectives, my authorities will implement the measures described in the Memorandum of Economic and Financial Policies in the fiscal, monetary, and structural areas, while improving governance and addressing poverty.

Fiscal policy

The 2000/01 budget will be a key step toward budget consolidation. Thanks to higher oil prices, privatization proceeds, and the interim HIPC resources, Cameroon should realize a stronger fiscal position. Primary surplus would reach 7.6 percent of GDP and the overall surplus (excluding grants) would improve to 2.1 percent. The improved fiscal stance would help clear domestic arrears, and reduce the indebtedness to the domestic banking and financial sectors. The authorities have decided to save part of the additional resources provided by the oil windfall and privatization proceeds at the Central Bank (BEAC). They are also determined to further increase non-oil revenues through reforming customs administration and improving domestic tax administration, notably by broadening the tax base, and strengthening the collection of VAT and the forestry tax. On the expenditure side, the authorities are committed to increasing the spending in the priority sectors of education, health, rural development, and basic infrastructure in line with the HIPC objectives. Total expenditure will be contained at 18.7 percent of GDP. My authorities are determined to address public expenditure management weaknesses through the strengthening of the institutional capacities of the spending departments and conducting the financial and physical audits of key ministries. They will also pursue the reform of the procurement system, generalize the use of the unique taxpayer identification number (TIN), carry out a multiyear settlement plan to follow-through the audit of domestic arrears, and use the recent census of civil servants to rationalize staffing and salary levels.

Monetary policy and reforms in the financial sector

The 2000-01 monetary policy implemented by the regional central bank will focus on increasing Cameroon's contribution to the net foreign assets position of the regional central bank. At the national level, it will reduce

net credit to the Government so as to make room for increased resources for the private sector in order to foster growth. In the financial sector, my authorities will support the strengthening of the capabilities of the regional banking supervisory body (COBAC) and its increased independence. As the banking sector has been rehabilitated, my authorities will focus on improving the regulatory framework and prudential supervision of non-bank-financial institutions; including the strengthening of microfinance institutions (COOPEC), the restructuring/privatization of the main insurance company (SOCAR), the rehabilitation of the state-owned postal savings bank, and the restructuring of the real estate bank (Credit Foncier) and Société Nationale d'Investissement (SNI). Finally, my authorities will launch the implementation of the recommendations of the FSAP, including the modernization of the payment system and the strengthening of the judicial system.

Structural Reforms

My authorities are determined to accelerate and broaden the scope of structural reforms in agro-industry, public utilities, transport and petroleum sectors in order to stimulate investment, enhance competitiveness, and foster growth. To this end, they will finalize the privatization of utilities (water, telecommunications and electricity), while taking steps to strengthen the newly established regulatory agencies. In the transport sector, the restructuring of the port of Douala will be completed and its commercial activities will be privatized. A new momentum will also be given to the privatization of the national airline (CAMAIR), and the road fund will be strengthened. As regards the petroleum sector, the authorities will build on existing efforts to improve transparency and revenue collection. These efforts will be complemented with appropriate sectoral strategies to spur growth in areas where Cameroon can build a comparative advantage.

External sector policies and debt management

The main objectives are to enhance competitiveness and promote non-oil exports in order to achieve external viability and strengthen growth prospects. Thanks to prudent domestic policies, the external current account will be strengthened. The capital balance will benefit from the reduction of debt service outflows as well as from investment in privatized companies and the Chad-Cameroon pipeline. My authorities will take advantage of this improved economic environment to deepen trade liberalization and foster regional integration within the framework of CEMAC so as to improve growth prospects. On the debt front, my authorities are eager to normalize relations with external creditors. In this regard, they have recently initiated negotiations with the Paris Club and expect to finalize them following Board approval of the new PRGF. They are also proceeding with the preparation of

the London Club. They are confident that the financing gap will be closed with the successful completion of these round of discussions.

Governance

In line with their I-PRSP, my authorities are determined to enhance transparency and accountability. To this end, the 2000/01 program puts a special emphasis on public expenditure management, the overhaul of the procurement system, increased transparency in the oil sector operations, and privatization of public enterprises. Specific measures will entail the audits of several institutions, including the national oil company (SNH), the Government procurement system, the road fund, the special fund for forestry, and the utilization of the HIPC resources. To improve transparency and foster enforcement of decisions, my authorities are determined to adopt an action plan for the establishment of the various jurisdictional structures, including the "Chambre des Comptes" called for in the constitution and publish new guidelines about conflicts of interest involving civil servants.

Use of HIPC resources and Poverty Reduction policies

The main objective of my authorities is to ensure that improved economic conditions translate into tangible results in terms of poverty reduction, job creation, and genuine improvement in the economic welfare of the population as a whole. To this end, my authorities will primarily use the interim HIPC resources for education, health, delivery of social services, urban sanitation, and basic infrastructure, as reflected in the 2000-01 budget. They have taken specific measures, including the establishment of a special account at the central bank, the setting-up of a monitoring committee with membership of donors and the civil society and regular independent audits in order to ensure an efficient use of HIPC resources, and the tracking of expenditures and an adequate monitoring of their impacts. In other to ensure the success of the program, stronger social and poverty indicators will be developed. They expect to complete the final PRSP in November 2001.

Conclusion

Based on the country's track record in program implementation, and the commitment of my Cameroonian authorities to reforms, I would like to ask the Board's support and approval of the new PRGF.

Mr. Rustomjee submitted the following statement:

The observation that our Chair made earlier this year that the Cameroonian authorities seem to have turned a new leaf on economic management is further strengthened by the positive picture that characterizes the current staff report. This is a good example of the pivotal role that

ownership can play in advancing the process of economic reform, especially when the government demonstrates the will to tackle difficult issues of governance and institutional gridlock. An anticorruption campaign has been launched; the government's role in the economy is being streamlined through an ambitious privatization program; fiscal management is becoming more and more transparent; and there seems to be a genuine effort to broaden the scope of participation in the process that is being developed to fight poverty.

At this juncture, it is important that Cameroon continue to receive the requisite level of financial support from the international community, and, in this connection, we give our full support to the request for Fund financial assistance under the PRGF. But such assistance is only a small part of what is needed. Cameroon also needs significant debt relief, and not just in the context of the HIPC Initiative. Debt relief on commercial debt and other forms of relief are an important part of the financing equation. External budgetary support will also be needed to help the program through to a successful conclusion. We note with some concern, therefore, that the staff have cautioned about uncertainties regarding this type of assistance. The record in Cameroon in recent years indicates that the authorities are making the right moves to strengthen their economy—the present program going further with so-called second generation reforms aimed at higher growth and poverty reduction. The donor community, in renewing its commitment to developing countries, has stated that strong domestic policies would be the basis for increased support, and we hope that Cameroon would benefit accordingly.

The realization of higher growth—projected at 5.4 percent in 2000/01 and 5.7 percent in 2001/02—will be an important test of the program's success. However, the main question is, is this sufficient to put Cameroon on target to reduce poverty by half by 2015? In any event, reducing Cameroon's vulnerability to external shocks has to be a key element of its long-term growth strategy, requiring the strengthening of the productive base of the economy through diversification. In this connection, Cameroon has to have a much higher level of investment, both public and private. This will be a major challenge. Table 2 shows that gross domestic investment in 2003/04 is projected to be only 1 percent higher than in 1997/98, an indication that this is an area that needs continued attention. As for private investment, the scenario for 2000-2002 shows only a small increase of about 0.5 percent relative to GDP. Could the staff comment on the medium-term prospects for private investment and how it could help to accelerate diversification? The goal of a more inclusive growth requires continued focus on policies that would increase employment. It would be useful to get some indication of the extent to which privatization has enhanced prospects in this regard, or increased the participation of domestic entrepreneurs in the economic life of the country. Comments from the staff would be appreciated.

On fiscal management, the authorities have acted appropriately to accelerate the timetable for settling arrears, benefiting from higher oil prices and privatization receipts. It is not clear, however, why there is any necessity for adding a quantitative benchmark on the minimum reduction of domestic arrears to the program. How would the program have been harmed without this new benchmark?

The fact that the bulk of the oil windfall and the privatization proceeds have to be kept in the bank due to what the staff call limited expenditure implementation capacity should ring a loud bell about the importance of providing technical assistance to Cameroon. Perhaps, the next worse thing to widespread poverty is not being able to use available resources effectively and in a timely manner to fight poverty. Although the capacity issue has been raised in the context of the budget, it is much more than that. At the core is the inability of the public sector to develop, implement, and monitor programs and projects, a problem which would also affect Cameroon's use of resources made available from the HIPC Initiative. It should be noted, in this regard, that in 1999/2000, only about half of the planned public investment was implemented. Problems of this nature underscore the importance we attach to capacity building in the poorer countries.

In sum, we are very encouraged by developments in Cameroon. Difficult challenges remain. But there seems to be a renewed seriousness on the part of the authorities to meet these challenges head on. In doing so, the authorities need the strong support of the international community. The PRGF-supported program should be seen as a catalyst for mobilizing the appropriate level of financing. The program appropriately targets stronger growth. For the longer term, the real economy would have to be strengthened through higher public and private investment. The authorities will also need to continue to give priority to capacity building.

We wish the authorities well in their endeavors.

Mr. Kelkar and Mr. Jayatissa submitted the following statement:

Cameroon has performed well under the PRGF arrangement and reached a decision point under the enhanced HIPC Initiative. It has maintained a satisfactory economic growth rate with a significant reduction in consumer prices and a strengthened external position. Considerable progress has been made in financial policies and in the structural reforms which are of critical importance to pave the way for higher and sustainable economic growth. We commend the authorities for the satisfactory completion of the three-year PRGF arrangement, particularly for their commitment to economic reforms, normalization of relations with external official creditors, and improvement in governance.

We note that, as staff have rightly pointed out, the achievements are fragile and easily reversible. In addition to improved economic management, the Cameroon economy has greatly benefited by the oil price boom. In this context, we are encouraged that the authorities' economic program for the next three years has set in motion a significant growth in the non-oil sectors. It is essential that many remaining structural weaknesses are eliminated speedily to facilitate enhanced private sector-led growth. We commend the authorities for their commitment to an ambitious economic reform program under the proposed new PRGF arrangement.

We are encouraged by the authorities' determination to make further progress in the privatization drive. Could the staff further elaborate the complications relating to the privatization of Cameroon Development Corporation (CDC). Is it not easier if it is sold as four separate entities? What is the experts' advice on this matter? We fully share the staff's advice to the authorities that independence and integrity of the newly created regulatory bodies need to be ensured for the privatization to be meaningful.

As the staff has pointed out, improving transparency and accountability of the public sector, including the implementation of measures to reform customs administration, would create a more conducive environment for private investment, speedier economic growth, and improvement in poverty indicators.

We wish the authorities all the success in their endeavors.

Mr. Daïri submitted the following statement:

Cameroon has made impressive economic progress in the last three years under the PRGF-supported program. We commend the authorities for their performance and for reaching the decision point under the HIPC initiative. We also add our voice to Mr. Rustomjee's call for increased level of financial assistance to Cameroon to ensure a successful implementation of its development agenda.

Remarkably, the authorities have managed to steer the economy along a path of stability and growth—always a delicate balancing act. During this period, growth has been maintained at close to 5 percent on average, and inflation has been subdued through prudent fiscal and monetary policies. Particularly noteworthy is the progress made toward fiscal sustainability. Significant progress has also been made in the structural area. Reforms in the financial sector are expected to enhance competition and efficiency in the delivery of financial services. The privatization of public enterprises and utility companies is also expected to foster efficiency gains and to help fiscal consolidation through reduced budgetary transfers and increased tax revenue. It is noteworthy that great attention has been paid to the social sectors, in

particular through the adoption of education and health sector strategies and the campaign against HIV/AIDS. It is also commendable that the authorities have cleared all external payment arrears and have normalized relations with bilateral and multilateral creditors.

Despite these achievements, the authorities still face serious challenges in economic management. As indicated by Mr. Barro Chambrier in his helpful statement, the economic situation remains fragile, with investment hindered by structural rigidities, cumbersome procedures, weaknesses in governance, and high transaction costs. The country is vulnerable to price shocks in oil and primary commodities, on which it relies for the bulk of its external receipts.

The authorities are to be commended for successfully preparing an interim PRSP, which, in addition to emphasizing poverty-reduction measures, provides for a strategy to improve governance and reduce corruption, which is key to improving the international image of Cameroon. The proposed program to address social policy concerns and alleviate poverty is commendable, particularly for its emphasis on health and education. We are pleased with the extensive participatory consultations in the preparation of the interim-PRSP. We are also satisfied that the interim PRSP forms a sound basis for ensuring economic stability, alleviating poverty, and improving governance in Cameroon. As suggested by staff, in preparing the final PRSP, the authorities should pay attention to the prioritization of objectives, sequencing of policies and reforms, and consultative and participatory process.

We agree with the thrust of the new PRGF-supported program, in particular in aiming to consolidate and sustain achievements of the last three years and establishing a strong foundation for the next phase of reforms. The stipulated targets for inflation, external balance, and real growth are appropriate. We take note of the staff's concern that recent economic achievements in Cameroon are fragile and potentially reversible. As is often the case, fiscal consolidation—or lack of it—holds the key to overall future economic performance. It is in this vein that we welcome the proposed measures to improve fiscal performance under the new PRGF. In particular, it is pertinent to carry out the much-needed customs reforms, improve public expenditure management, accelerate the pace of privatization of public enterprises, and reorient public spending in favor of social sectors. The proposed package of measures (elaborated in Box 3) to improve governance through increased transparency and accountability is noteworthy. This is key not only to enhancing efficiency of government operations, but also to stimulating private investment in Cameroon. It is hoped that additional measures will be implemented to reduce what staff has identified as major impediments to private sector investment and equitable growth.

We agree with staff that the proposed policies and reforms may look ambitious, but are realistic and necessary, and form a sound basis for achieving program objectives.

We also share the staff's assertion that Cameroon merits the support of the international community to increase the momentum of its development agenda. We support the proposed decision.

Mr. Beauregard submitted the following statement:

At the outset, I would like to thank staff for a candid analysis of the current situation and prospects in Cameroon and Mr. Barro Chambrier for his helpful preliminary statement. I would also like to commend the authorities for their efforts to implement coherent macroeconomic policies and a broad poverty reduction strategy.

After reading both papers, my impression is that Cameroon is at a very important point in his fight against poverty. During the past three years, the authorities have achieved considerable progress in their macroeconomic management, as envisaged by the economic growth and inflation rates attained during the period. Structural reforms were implemented, as well as a broad social and poverty alleviation strategies. In terms of governance and anticorruption strategies, progress has also been made. All these reflect how committed the authorities are in their fight against poverty, although much remains to be done, in particular in the structural area.

Sustainable economic growth is key to fight poverty. In that sense, besides maintaining the solid fiscal position that has been built in the last few years, the authorities should reinforce their actions to enhance the participation of the private sector in the economy. A correct legal framework should be developed and a more efficient economy should be the goal through the elimination of all those practices that may inhibit the participation of the private sector in the economy.

Staff mentions that there are several factors that may attempt against the consolidation of the achievements of the last three years. Mainly all these factors seem to be domestic in nature. With regard to external shocks, staff mentions (page 17) that the new program will contain contingency mechanisms to tackle those factors that may reduce the availability of external resources. Can staff elaborate more on these mechanisms? Given the recent events in oil markets, how does the price of oil that was used for budget purposes look like?

As is the case with other countries under PRGF arrangements, we strongly encourage the authorities to continue their efforts to work on the new household consumption survey. More and better statistical information,

particularly social indicators, are crucial to a better understanding and monitoring of the advances in the fight against poverty.

With these remarks, we support the authorities' request for a new PRGF arrangement and we wish them the very best success in their endeavors.

Mr. Barro Chambrier informed that Board that, as had been the case with the previous review, the Cameroonian authorities had agreed to the publication of the letter of intent.

Ms. Redifer made the following statement:

We agree with the staff assessment that Cameroon has made significant progress on structural reform and macroeconomic adjustment. We agree with the emphasis of the new program, and so will restrict our comments to a few issues.

We are very pleased to see the progress made on stipulated uses for HIPC interim relief, and provisions for its monitoring, as outlined in Box 2 of the staff report. The two-page summary supplement provided by staff (today) is precisely the type of information we think is needed to provide needed accountability during the interim period. We recognize that this is the government's draft that still must be considered by the monitoring committee. We understand there have been delays in pulling together the monitoring committee, and we encourage expedient action in overcoming them. Overall, we feel this presentation can be used as an example for other HIPCs, many of which need to provide more information on the use of interim HIPC resources in conjunction with upcoming program reviews. Staff is hopeful that the Cameroonians' monitoring of the use of interim relief will provide a base for strengthening expenditure management and monitoring through the budget. We agree.

The establishment of a strong monitoring concept is not tantamount to effective implementation, however. While the priority expenditures identified should be "traceable," it remains to be seen how monitoring will be implemented on a decentralized level. Our understanding is that controls at the local level are weak, and that institutional changes will be needed to handle the larger inflow of resources to ensure that they are used well. The authorities will need to focus on the decentralization point as the new system becomes operational.

Similarly, we were pleased with the comprehensive governance agenda laid out in Box 3 of the staff report. Cameroon has a poor history on issues of governance and transparency, and the international community will be watching closely to ensure these commitments are translated into concrete actions.

With regard to development of the full PRSP, I would like to underscore staff's point in paragraph 39 that the authorities take as much time needed to develop a full PRSP. Cameroon has a long way to bring the delivery of social services to an adequate level. The authorities should take all the time needed to develop a strong poverty reduction and growth plan that can serve the country well over the coming years. Also, the country does not have a longstanding tradition for public participation, and time is needed to cultivate ownership in the reform strategy.

Finally, let me conclude by echoing the comments of my colleagues that the combination of oil windfalls, strong privatization receipts and HIPC assistance will impart a large amount of new resources. The authorities have committed under the program to build down sharply domestic arrears and reduce net credit to the government, while reducing the deficit. We welcome these commitments. However, this abundance should not divert the authorities' attention away from more fundamental reform needed to increase the revenue effort, particularly for non-oil revenues, more durably, including via customs reform.

Mrs. Boucher made the following statement:

Staff has produced a comprehensive and candid report and, at the outset, I can confirm that I concur with the staff's conclusion and recommendations and support the proposed decision.

The growth targets set in the program are ambitious, but, in our view, achievable if the authorities maintain the sound policy which translated into a very satisfactory track record during the past three years under the PRGF-supported program. As stressed by staff, these achievements are still fragile and easily reversible, and I would like to very briefly focus on a few issues, on which we believe the authorities should concentrate their efforts.

First, on the fiscal stance, we agree that the broadening of the tax base, together with the controlled increase in expenditures in priority areas, including the education and health sectors, should contribute to the stabilization of the budget while fostering growth.

Second, we welcome the creation of the special account at the BEAC, in which a significant part of the oil windfall and the privatization proceeds will be saved. Indeed, the authorities will need to engage in an even more prudent expenditure management policy, given the large inflows that will be generated by additional oil revenue and privatization, as well as assistance under the HIPC initiative.

Finally, in the same vein, the program rightly puts a strong emphasis on governance. Here, we would like to comment more specifically on the privatization process. We urge the authorities to provide the regulatory agencies with adequate operating means in order to ensure that the public services which are already, or about to be, transferred to the private sector will be efficiently managed and will provide better service and more competitive pricing for end users, as it is the final objective of this privatization process.

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

Mr. De Blasio made the following statement:

The new program is well designed and we support its main objectives. Specifically, following the successful completion of the first PRGF-supported program, we concur that it is appropriate to aim at consolidating the significant gains made in macro stabilization, while simultaneously pursuing a much more robust and ambitious reform agenda. The ultimate target should be to achieve an environment that is free of distortions and the corruption usually associated with them, so as to stimulate private sector development. At the same time, the authorities should concentrate on effectively and transparently delivering poverty reduction measures.

I have three remarks.

First, the financial position of the government seems to be in a very good shape. There are three reasons for that—booming oil revenues, privatization proceeds and HIPC assistance. This prompts me to ask a first and perhaps trivial question: does the country need to draw now on PRGF resources? In particular, the staff recognizes in paragraph 16 that expenditure implementation capacity is limited. In their view, which I share, this calls for depositing part of the oil revenues and privatization resources into a central bank's account. The question is: what is the point of giving them money if it cannot be spent? While I note that the proposed access is not particularly large, I would appreciate it if the staff could elaborate on the rationale for the proposed financing. On this front, I am sympathetic to the call of Mr. Rustomjee for additional technical assistance to Cameroon. I would just add that perhaps sometimes there is something that money cannot buy, while TA perhaps can do a lot.

We are also concerned that ample availability of resources could lead to a renewed surge in rent-seeking activities. On this front, I fully share the staff assessment that, on the corruption and transparency front, achievements have been good, even though much remains to be done. We believe that for a country receiving such a significant amount of foreign assistance mainly for poverty alleviation, a priority for the authorities should be to explain clearly

the intended purposes of their measures. In this regard, the rationale for the cap on the retailed price for oil is not clear; in particular, we wonder about the effects of this measure on poverty. In any case, we understand that this is a temporary measure and we look forward to its being phased out.

We agree with having a ring-fencing mechanism and a monitoring committee for the HIPC expenditures. However, at the time of the last Board meeting, we warned that while special accounts for poverty-related expenditures could represent the right approach in the medium term, this procedure carries the risk of creating a double monitoring standard respectively for the HIPC special account and for the overall budget. We are worried that while the HIPC special account would be closely monitored, similar procedures would not be applied to the main budget as well. It would be indeed unfortunate if what is gained in the fight against poverty through the use of HIPC-related resources is then lost because of ineffective and distorted budgetary choices. The long-term outcome should be to fully re-consider the funds saved through debt relief as part of the overall budget. To this aim, the authorities should strengthen the whole budgetary process. In this regard, we welcome the commitment by the authorities to strengthen expenditure management and the procurement system.

Mr. von Kleist made the following statement:

Since I agree with the thrust of the staff appraisal and most of the points made by previous speakers, especially Mr. De Blasio, I would only make three points.

First, Cameroon is the last, but certainly not the least, of the HIPC cases for this year. The reform process and adjustment efforts in all of the HIPC cases bring to my mind the saying by Confucius, “Even the journey of a thousand miles begins with the first step.” In this sense, the authorities are to be commended for the first bold steps on the reform journey. Cameroon’s macroeconomic indicators improved markedly, which is very welcome. However, staff notes that the situation remains fragile and easily reversible, and it is of utmost importance to seize the opportunity of a favorable external environment to implement those structural measures to help provide sustained development. It is important to broaden the revenue base, since privatization receipts and windfall profits on oil prices have to be treated as one-time gains.

Second, corruption or, in a broader sense, bad governance, remains a problem. While it has to be acknowledged that Cameroon has made progress, the negative effects of the continued governance problems, especially regarding foreign investors and the economic prospects of the poor, should receive the authorities’ undiluted attention.

Third, the arbitrary ceiling of $25 for domestic oil prices, which results from the automatic retail mechanism, is a typical bad example of middle- and upper-class subsidy that is introduced under the veil of supporting the poor. In a PRGF-supported program, I would have expected a better targeted solution, for instance, direct fuel cost support for the truly needy. In addition to squandering budgetary resources, the automatic retail oil price mechanism interferes with the market price mechanism, distorting signals, and therefore choices.

With these remarks, I support the proposed decision.

Mr. Kelmanson made the following statement:

We are grateful to staff for the paper before us today and can support the request for the new arrangement. While Cameroon's performance under the previous arrangement was satisfactory, the impact of the program on poverty was certainly muted. The challenge for program design in this program and subsequent annual arrangements will be to ensure that we move beyond maintaining macro stability, but also improving growth prospects and ensuring that the budgets and the program are more pro-poor. Important in this will be a careful link between the PRGF and the full PRSP as it evolves.

Given the extent and depth of poverty in Cameroon, we wonder if there are ways of expanding government expenditure, which would crowd in private sector expenditure rather than crowding it out. Although social sector spending is due to rise, the figures are still rather low, and we would welcome staff comments on why the government of Cameroon needs to run a fiscal surplus even when defined before grants. Staff sufficiency and the capacity of spending could affect and change it in the future.

On governance and corruption, there remains a serious problem on auditing, which will need to be fundamentally addressed. Thus, while we welcome the strong emphasis given to economic governance in the program, we believe that progress here needs to be significantly deepened. Governance is relevant across the full range of economic activity, and progress is vital in all, but let me touch basically on three.

On public expenditure management and transparency, as set out helpfully in Box 2, we continue to stress the need to ensure that this strengthens national budget processes, so that all sector work fits with detailed sector strategies, rather than risks evolving stand-alone projects.

On privatization, a point which Ms. Boucher mentioned, we welcome the progress made in the promotion of private sector investment in telecommunications and the liberalization of the mobile phone system, but the process here and in other sectors, along with effective regulatory frameworks,

should ensure that negative weaknesses do not rise. Weaknesses here will only act to hinder further investment.

One final area where we believe there is a stronger need for emphasis on governance and careful link between the PRSP and the PRGF is the forestry sector. It is one of the cornerstones for poverty alleviation in Cameroon, in particular rural poverty. Reform of this sector will also make a substantial contribution to the external position and fiscal receipts. We need to develop better indicators of reform and monitor the real impact of policy measures undertaken. The HIPC document, which we discussed some time ago, includes forestry measures that will draw effectively from the government's own plans, and we wonder how these would be monitored in an ongoing way within the Fund-supported program.

The forestry sector is an area where governance is important, and actions will be needed beyond the publication of the independent observers' report on concessions. The staff will need to identify further actions to ensure that these concessions and their allocation are done in an effective and transparent manner, and that if any inappropriate activity becomes evident, full measures will be taken.

On the development of the full PRSP, integration with the PRGF and public participation will be vital. The preliminary consultations to develop the I-PRSP, which we had previously discussed, must be built into a truly comprehensive participatory process, and the PRGF must draw on this. It may be best to develop this kind of approach on a sector-by-sector basis, and the United Kingdom is ready to help in the development of such a process within the forestry sector.

To conclude, root-and-branch reform to address corruption and service delivery is needed in Cameroon. Progress has been made toward macro stability, and this must be maintained, along with ongoing commitment to reform on the part of the authorities, and increase specificity and subsequent annual arrangements on the part of staff.

Mrs. Zador made the following statement:

Cameroon successfully completed its first three-year PRGF arrangement this October. It has a credible track record of good performance, with economic conditions continuously improving since the first Fund-supported adjustment program in mid-1997. Cameroon's good performance has been acknowledged, and the Board has set its decision point for assistance under the enhanced HIPC Initiative.

The new medium-term PRGF arrangement now being requested aims at continuing Cameroon's previous good performance. I support it without

hesitation. The program is appropriately aimed at establishing durable private-sector led growth to serve as the basis for a meaningful poverty-reduction strategy.

Where HIPC countries are involved, the focus is always on whether the resources saved by the Initiative will be used for poverty reduction. To me, the programs to be financed by the HIPC resources (listed in Box 2) and the measures aimed at improving governance (listed in Box 3) are appropriate and reassuring. My only concern is lest all these good intentions be frustrated by Cameroon's generally weak administrative capacity. I agree with Mr. Rustomjee's remarks on this. Cameroon badly needs technical assistance with almost every phase and level of economic and social management. In addition, there are serious deficiencies in data collection and dissemination, so essential for program evaluation. The staff report sounds the alarm on these flaws in Appendix IV. Let me quote some statements from the report:

"The socio-demographic statistics are outdated and the coverage of health and education statistics is poor. The lack of communication among statistical units, the lack of resources, training and material do not guarantee an adequate collection of row data. For effective monitoring of the PRGF arrangement, projects would need an urgent impetus from the Cameroonian authorities to expedite the undertaking of the Third General Census of Population and Housing." In addition, there was no information at all on the financial operations of local governments.

The situation may not be as bad as it looks at first glance. Still, I think it will be crucial to create the basic infrastructure for program monitoring and evaluation, although this will require serious funding. It was my general impression from the staff report that there has been no adequate response to these problems, which threatens successful program implementation. A more focused approach, concrete projects, and identification of potential financial resources will be needed if the PRGF-supported program is to succeed.

Mr. Liu made the following statement:

The authorities should be commended for their effort on comprehensive economic management and structural reform policy, as well as broad Poverty Reduction Strategy. Generally speaking, the authorities have successfully completed their first three-year PRGF-supported program and reached the decision point on the enhanced HIPC Initiative. The great achievements of the program are the strengthening of public finances—particularly in oil and domestic and nonoil revenue mobilization—rehabilitation of the domestic banking system, normalization of relations with external creditors, and lunching of ambitious privatization and governance programs. Real GDP growth reached 4.7 percent and inflation declined to low levels. I also joined Mr. Rustomjee and Mr. Dairi in calling for increased

levels of financial assistance to Cameroon to ensure a successful implementation of its development agenda.

Despite these achievements, the authorities face serious challenges in economic management. As mentioned by Mr. Barro Chambrier, the economic situation remains fragile, hindered by structural fragility, cumbersome procedures, weakness in governance, and high transaction costs. Therefore, the authorities should consolidate the gains made over the past three years and establish a solid foundation for the next phase of reforms to create conditions for sustainable growth and durable poverty alleviation.

It is commendable that the authorities are making an effort to further increase oil revenues, reform customs administration, and improve domestic tax administration, as well as broaden the tax base and strengthen the collection of VAT and forestry tax. We also welcome the authorities' commitment to increase spending in the priority sectors of education, health care, rural development, and basic infrastructure, in line with the HIPC objectives. We are pleased to learn that the authorities are taking steps to address public expenditure management weaknesses so as to strengthen institutional capacity, and undertake the financial and fiscal auditing of key ministries.

Given the authorities' track record in program implementation and their strong commitment to reforms, I share staff's assertion that Cameroon merits support of the international community to increase the momentum of its development agenda.

We fully support the proposed decision. With these remarks, we wish the authorities every success.

Mr. Whitehall made the following statement:

The authorities have made significant progress in recent years in improving macroeconomic stability, strengthening public finances, improving relations with external creditors, restructuring the banking system, and privatization. However, these improvements have not reduced poverty and Cameron is ranked by the UNDP as one of the poorest countries. Given the satisfactory completion of the first PRGF-supported program, we support staff's assessment that the challenge is now to establish a solid foundation for the next round of reforms to strengthen governance and accountability so that poverty can be reduced.

We are pleased with the emphasis in the PRGF document (in Box 2) on monitoring and control mechanisms to improve governance and ensure transparent use of the resources freed up by the HIPC debt relief. We note that a "ring-fencing" mechanism at the central bank and a monitoring committee

have been established to ensure that resources from the debt relief are used for poverty reduction, health, education, and rural development as set out in the interim PRSP. This is a useful mechanism, but we expect that it will be temporary pending the development of the effectiveness of more normal budgetary procedures.

The transparent and productive use of windfall revenues from oil fees from the Chad-Cameroon pipeline and the privatization of state enterprises is also important, particularly in light of the recent disclosure of the non-productive use of pipeline revenues by Chad. I guess it is not possible to ring fence the oil sector, in the same way that we have ring fenced HIPC proceeds, but perhaps staff can tell us how the issue of protecting oil revenues will be addressed in their action plan in the light of the preliminary findings of the audit of the SNH (national oil company).

We are also pleased with the focus on governance issues (outlined in Box 3), particularly as it relates to improving the operations of the oil sector, increased accountability in government procurement, and judicial reform. We agree with staff that improved governance is required if Cameroon is to secure lasting benefits from on-going economic and structural reforms, and to attract private sector investment.

In our view, the National Governance Program of the authorities is very ambitious and will require significant capacity building using technical assistance provided by the multi-lateral institutions.

Finally, we want to wish the Cameroonian authorities every success as they persevere with their reform agenda.

Mr. de los Santos made the following statement:

Cameroon's economic performance under its first three-year PRGF-supported program has been formidable. The government has shown strong commitment to attain the goals set forth in the program. For the current fiscal year, the country experienced strong economic growth rate, very low inflation, strengthened external position, and some advances in its fight against poverty

Additionally, the authorities have been very successful in the implementation of the social and economic reforms outlined in the program. Among the most important measures, we would like to highlight the strengthening of public finances and the launching of a large-scale privatization program.

The preparation and implementation of the I-PRSP has been taking place through an ample participatory process, thanks to an outstanding coordination of actions between the authorities and the civil society

organizations. This is an appropriate initiative to identify poverty targets as well as a means for implementing programs to reduce poverty. We consider the I-PRSP for Cameroon a successful experience, and we concur with the staff that it provides a sound basis for the development of a fully participatory PRSP and for Fund concessional financial assistance.

On this ground, we support the authorities' request for the new PRGF arrangement. Some additional remarks are in order, however.

Though the authorities have made commendable progress in fiscal management, stricter measures of expenditure monitoring and reporting should be adopted, in order to avoid the occurrence of budgetary slippages or the deviation of resources from the programs budgeted.

We share the staff's recommendation that the new regulatory agencies should operate with independence and integrity to guarantee that the privatization process will take place without any interference.

We concur with the staff that to complement higher oil revenues expected from price increases, a policy to augment non-oil revenues should be adopted, along with the implementation of an overhaul reform of customs administration as the main project.

The staff representative from the African Department remarked that, on the targeted growth and reduction of poverty, based on the HIPC Decision Point document discussed by the Board in October, 2000, real GDP per capita would grow by 65 percent over the next 15 years, and policy measures would be targeted to help the poor, consistent with the I-PRSP. Based on limited data on income distribution, and an estimated poverty line of about 50 percent of the population, the staff's simulations suggested that the targeted reduction of poverty by half by 2015 was achievable. However, a better assessment would be attempted when more data on household income and expenditure became available.

On the medium-term prospects for private investment and its contribution to economic diversification, the staff's projections for private investment were conservative, based on what was actually taking place, the staff representative said. However, more positive contributions could be expected from the pipeline activities, and those related to the privatization of the various entities. The staff hoped that private investment would increase by over 1 percentage point over the next three years. Also, public investment was targeted to increase significantly, and should highly complement private investment, given the currently poor conditions of Cameroon's basic infrastructure. Overall, the growth rates of both public and private investments could exceed the staff's projections. Those factors, together with improvements in the implementation capacity and the efficiency gains, would enable Cameroon to achieve, or even surpass, the projected growth rates. High potential areas that saw increased private investment included wood processing—which was growing rapidly—the agro-based industries, light manufacturing, and perhaps tourism over the medium and longer terms. Moreover, Cameroon would benefit from improved economic performance in other countries of the sub region.

On the impact of privatization on employment, experience with privatization, starting with that of the rubber company during the first year of the first three-year PRGF-supported program, was quite positive, leading to an expansion in employment, investment, and ultimately output, the staff representative noted. Despite some drawbacks resulting from the fall in rubber prices, the sector was currently recovering. Employment in other areas of the formal economy was also expected to increase, as some of the pipeline-related activities would be contracted or subcontracted by Cameroon companies, and road maintenance and construction would be undertaken in the period ahead.

The inclusion of a quantitative benchmark on the minimum reduction of domestic arrears was intended to address the weakness in the audit and validation system, which had been a major problem in the past, the staff representative related. It had taken the government a considerable amount of time to set up an exhaustive audit system and to validate the amount of government arrears. Fortunately for Cameroon, given the more favorable situation regarding oil revenue and privatization, it was an opportune moment to clear all the domestic arrears that had been scheduled for clearing by cash initially over a period of five years, in line with the set targets and ceilings as would normally be preferred by the authorities. That was part and parcel of the financial program and the cash flow, and thus should not pose any problems to the authorities. Moreover, past experience had suggested that the Cameroonian authorities had tended to meet concrete specific targets.

With respect to the contingency mechanism in the event of external shocks, the staff representative remarked that no major problem was envisaged on this front, as the targets for foreign financing under the program were conservative, and the contingency mechanism allowed for 50 percent absorption of such shocks. Such a mechanism had worked rather well during the three years of the first PRGF-supported program, and the targets for end-December 2000 were largely met.

The baseline price of oil in the budget had been raised to $28.30 per barrel for 2000/01, from the original price of $21.30, in line with the *World Economic Outlook*, which was normally used as a benchmark for the staff's projections, the staff representative said. The authorities had almost reached the quarterly fiscal target in the first two months of the second quarter. The drop in oil price to $24-25 in the past few days, if sustained, might have some consequences in the third quarter of the program - January to March 2001. Nevertheless, the authorities had the ability to absorb at least 50 percent in the context of the mid-term review, when the baseline price would be re-examined. Such a development led to a temporary cap on the oil price for consumers. The authorities' proposal was acceptable, given its short-term nature, limited implementation capacity on the part of the authorities, and the budget surplus. If the oil price remained below $25 per barrel, that would not be an issue, as the cap would not be binding. In the context of the mid-term review, measures that were better targeted to help the poor would be sought.

As regards the privatization of the Cameroon Development Corporation (CDC), the option recommended by the experts was to sell the four activities of the company separately, but a question remained as to what would be the best option for the headquarters of the

company, the staff representative noted. There was also a question of land tenure as land belonged to the indigenous population of that area. As the CDC was the largest employer in Cameroon, with 13,000 employees, the privatization approach would have to be carefully considered to minimize the effects on a large number of families.

On the expenditure side, experience with HIPC resources would become the basis for improving all other priority expenditures, the staff representative commented. Cameroon had received technical assistance in expenditure management from the Fund, the Bank, and other donors, which would, over time, help enhance the capacity and the efficiency of government spending. There had already been some personnel changes and a change of attitude, but the whole process was expected to take time.

A mechanism had been set up to enhance transparency in forestry sector revenue collection, under World Bank supervision, the staff representative said. An independent observer was henceforth present during the allocation of concessions. Related to that, the Tax Department within the Minister of Finance had initiated a plan to improve tax collection and verification of taxes paid by the forestry sector. There was also a program to allocate efficiently resources to the local communities, and to enhance transparency in the utilization of those resources.

With respect to the protection of oil revenues, the staff representative stressed that the issue had been the priority of the first PRGF-supported program, with focus on setting up independent audits and ensuring that oil revenue came under the budget. That mechanism was working rather well, and monthly and quarterly reports were also produced. The accounting practices of the national oil company had improved; the company was subjected to annual financial audits by an internationally reputable accounting firm.

The compilation and quality of data needed for program monitoring had improved substantially, the staff representative remarked. Reliable data were produced by the regional central bank, the quality of budgetary data on a treasury basis had improved, and the computerization was under way. A major challenge remained, however, in the social and poverty-related areas. The household survey and other related activities were expected to help address that problem.

Finally, on the rationale for the proposed Fund financing, the staff representative stated that the situation was still fragile and Cameroon needed financial support from the Fund, as well as a formal medium-term program to facilitate support by other donors. The confluence of positive events - such as the high oil prices and privatization - was almost a one-off phenomenon, and, as evident, oil prices had already declined substantially, suggesting how fragile the scenario was. To enable Cameroon to benefit from the HIPC Initiative, the Paris Club required a formal Fund-supported program. Upon Board approval, the Paris Club would meet in January 2001 to consider debt rescheduling for Cameroon, the outcome of which should help strengthen its external position. At present, Cameroon had no gross reserves, as such being a member of the Economic and Monetary Community of Central Africa

(CEMAC) and not having its own independent central bank. The staff was of the view that Cameroon was qualified for continued PRGF support.

Mr. Barro Chambrier made the following concluding statement:

At this late hour of the day, I will try to be brief. First, I would like to thank my colleagues for their support and constructive comments that I will convey to my authorities.

I want to thank the staff for their comprehensive answers already provided. Based on my authorities' impressive track record in policy implementation under the first PRGF-supported program, I would like to reiterate their strong commitment to consolidate macroeconomic gains previously achieved, and implement forcefully the second generation of reforms in an area that will have a lasting impact on poverty. Your comments on the need for stronger action on governance, on broadening the scope of the participation in the fight against poverty, and on developing basic infrastructure, are well-taken.

I would like to focus on one interesting issue; the staff already gave a response, but I think Mr. De Blasio raised an interesting point with regard to the question as to whether the country needs to draw. And, to complement what was said by the staff, I think that there is a confusion. It is true that the situation has improved, but one has to bear in mind that this reflects the cyclical cycle of high oil prices, and I accord that the authorities need to strengthen the budgetary management. It is also to be taken into account the issue of using the extra resources that are going to be provided in the framework of the interim assistance. This is for social projects, and this is the area where the country really need to improve the capacity to absorb those extra resources.

What we are speaking about is the need also to face the financing gaps, because there is still a financing gap in the case of Cameroon, and, given the current account position, the authorities deserve to use Fund resources in the framework of the PRGF. Therefore, this is not related to project conception and implementation, and I would like to consider that this contribution of the Fund is going to be important. Therefore, the effort of the authorities alone will not be sufficient, given the important need.

The authorities need a continuous and adequate level of external concessional financing and technical assistance, and I believe in the catalytic role of the Fund. The efforts of the authorities during the last three years without any interruption of the program are making the difference in the case of Cameroon, and I think this is the most important point.

Let me say that the efforts of the key ministries to produce periodic reports, the effort to improve the public procurement system, the establishment of the juridical structure, and all the measures to improve the transparency and accountability of the management of public resources should help to make the difference in improving the social conditions of the population.

Let me once again thank Directors for the support of Cameroon's request for a new three-year arrangement under the PRGF.

Finally, I would like to extend my thanks to management and the staff, not only for their dedication, but also for excellent work on Cameroon by advising well my authorities.

The Acting Chairman made the following summing up:

Cameroon successfully completed its first three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in October, and reached the decision point under the enhanced HIPC Initiative. Under that arrangement, broad macroeconomic stability was achieved; a wide range of structural reforms, including large-scale privatization program, was implemented; and a governance and anti-corruption strategy was adopted.

Directors welcomed the authorities' intention to proceed with a further phase of reforms to create the conditions for sustainable and inclusive private sector-led growth and poverty alleviation. They recognized the importance of ensuring that structural reform and macroeconomic stability produced tangible benefits for the population and, in this connection, welcomed plans to make social services more efficient and widely accessible, as well as to develop basic infrastructure. Directors considered it critical that administrative capacity to implement the heavy agenda of reforms be reinforced, a task in which technical assistance could play a key role.

Regarding fiscal policy, Directors noted that higher oil prices, privatization receipts, and HIPC relief will considerably expand the resources available to the government. Directors stressed the importance of using these resources effectively, while continuing to implement other measures to strengthen the budget. Such measures on the revenue side of the budget include the long-delayed reform of the customs administration, reinforcing and modernizing tax administration, and broadening the tax base. Directors also underscored the continued need to clear domestic arrears, to improve expenditure management so as to ensure adherence to spending priorities on the social sectors and infrastructure, and to overhaul the procurement system.

Directors welcomed the authorities' commitment to ensure that the resources freed up by the HIPC Initiative are used efficiently and effectively.

They encouraged them to move forcefully to make the ring-fencing mechanism and the monitoring committee established for this purpose fully operational and effective, as a basis for strengthening overall expenditure management. Directors noted that, to facilitate the completion of the Poverty Reduction Strategy Paper (PRSP), a network of development partnerships will have to be developed, the collection of updated social and demographic indicators will need strengthening, and a household consumption survey should be carried out. They encouraged the authorities to take the necessary time to produce a PRSP of high quality and with a strong sense of local ownership. Directors noted the important potential role of the forestry sector in alleviating poverty, which underlined the importance of this sector being managed properly and honestly.

Regarding the structural reform agenda being implemented in close consultation with the World Bank, Directors attached particular importance to early measures regarding public utilities and the financial, petroleum, and transport sectors. The independence and integrity of the newly created regulatory agencies to oversee privatized public utilities should be assured. Ailing nonbank financial institutions in the public sector should be rehabilitated, and the monitoring of microfinance institutions strengthened. In the retail oil market, the authorities should remove the recently imposed cap on the automatic retail oil price adjustment mechanism and, if necessary as a substitute, target assistance to the most vulnerable groups.

Directors were encouraged by the authorities' actions and intentions to improve transparency and fight corruption, notably regarding the judiciary, the creation of the audit office (Chambre des Comptes), reform of public expenditure management, audits of all public sector entities, and the establishment of accountability for all holders of public office. Directors saw continuing efforts to improve governance critical to achieving the needed improvements in the efficiency of government operations, to improving the environment for private involvement, to the development of the financial system, and—above all—to reducing poverty.

Directors noted the important role of the international community in supporting Cameroon's poverty reduction strategy.

The Executive Board took the following decision:

CAMEROON—POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT

1. The government of Cameroon has requested a three-year arrangement under the Poverty Reduction and Growth Facility in a total amount equivalent to SDR 111.42 million.

2. The Fund notes that the interim Poverty Reduction Strategy Paper (PRSP) for Cameroon EBD/00/76 (9/19/00) provides a sound basis for the development of a fully participatory PRSP, and for Fund concessional financial assistance.

3. The Fund approves the arrangement set forth in EBS/00/255 (12/6/00) and decides that Cameroon may request the first disbursement under the arrangement, on the condition that the information provided by Cameroon on the implementation of the measures specified in paragraph 34 of the memorandum attached to the letter of the Prime Minister of Cameroon, dated December 6, 2000, is accurate. (EBS/00/255, 12/6/00)

Decision No. 12381-(00/129), adopted
December 21, 2000

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/128 (12/20/00) and EBM/00/129 (12/21/00).

5. FINANCIAL TRANSACTIONS PLAN FOR DECEMBER 2000–FEBRUARY 2001—AMENDMENT

The Executive Board approves the amendment to the financial transactions plan for the quarterly period December 2000-February 2001 (EBS/00/226, 11/14/00) set out in Table 1 of EBS/00/226, Supplement 2. (EBS/00/226, Sup. 2, 12/14/00)

Decision No. 12382-(00/129), adopted
December 20, 2000

6. POVERTY REDUCTION AND GROWTH FACILITY—ELIGIBILITY—PEOPLE'S REPUBLIC OF CHINA, ARAB REPUBLIC OF EGYPT, AND EQUATORIAL GUINEA

The list annexed to Decision No. 8240-(86/56) SAF shall be amended by excluding from it the People's Republic of China, Arab Republic of Egypt, and Equatorial Guinea. (EBS/00/266, 12/13/00)

Decision No. 12383-(00/129), adopted
December 20, 2000

7. REPUBLIC OF YEMEN—POVERTY REDUCTION AND GROWTH FACILITY—EXTENSION OF COMMITMENT PERIOD

The Republic of Yemen has requested an extension to March 1, 2001 of the PRGF commitment period set forth in EBS/97/172, Supplement 3 (10/31/97).

The PRGF commitment period for Yemen is extended to March 1, 2001. (EBS/00/267, 12/12/00)

Decision No. 12384-(00/129), adopted
December 20, 2000

8. ACCESS POLICY LIMITS IN CREDIT TRANCHES AND UNDER EXTENDED FUND FACILITY—REVIEW

The Fund decides that the next annual review of the guidelines and limits for access to the Fund's general resources in the credit tranches and under the extended Fund facility prescribed by paragraph 2 of Decision No. 11876-(99/2) shall be completed by June 30, 2001. (EBS/00/269, 12/13/00)

Decision No. 12385-(00/129), adopted
December 20, 2000

9. GROUP TRAVEL BY EXECUTIVE DIRECTORS

The Executive Board approves the recommendation concerning group travel to Africa by Executive Directors as set forth in EBAM/00/171 (12/15/00).

Adopted December 20, 2000

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by an Advisor to Executive Director and by Assistants to Executive Directors as set forth in EBAM/00/172 (12/19/00) is approved.

APPROVAL: August 15, 2001

SHAILENDRA J. ANJARIA
Secretary