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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 98/79

10:00 a.m., July 20, 1998

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Executive Board Attendance

S. Fischer, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors

A.A. Al-Tuwaijri

R.F. Cippà

B. Esdar

K.A. Hansen
A. Kafka
W. Kiekens
K. Lissakers

J.-C. Milleron

A.V. Mozhin
G. O'Donnell

M.R. Sivaraman
G.F. Taylor

J. de Beaufort Wijnholds

Y. Yoshimura

Zhang Z.

Alternate Executive Directors

M. Askari-Rankouhi, Temporary
T. Turner-Huggins, Temporary
W. Szczuka
R.J. Singh, Temporary
W.-D. Donecker
J. Spraos
A. Giustiniani, Temporary
L. Pinzani, Temporary
J.P. de Moraes
Y. Patel, Temporary

H.F. O'Brien
N. Goffinet, Temporary
B.S. Newman
M. Sobel, Temporary
S.D. Melese d'Hospital
T.T. Schneider, Temporary
R. Fernandez
P.M. Fernann, Temporary
S. Rouai, Temporary
A. Lushin

M.H. Elhage
S.S. Farid, Temporary
W.F. Abdelati, Temporary
N. Jadhav, Temporary

J. Guzmán-Calafell
E. Rodriguez, Temporary
Y.G. Yakusha
A. Barro Chambrier
D. Fujii, Temporary
C. Harinowo

N. Eyzaguirre

R.H. Munzberg, Secretary
A.S. Linde, Acting Secretary
A. Mountford, Acting Secretary
K.G. Fitchett, Assistant
P.J. Kunzel, Assistant

Haiti—1998 Article IV Consultation

Staff representatives: Guzmán, WHD; Muñiz, PDR

Central African Republic—1998 Article IV Consultation; and Enhanced Structural Adjustment Arrangement

Staff representatives: Maciejewski, AFR; Ferrán, PDR

Russian Federation—Extended Arrangement— Augmentation; and Purchase Transaction—Compensatory and Contingency Financing Facility

Staff representatives: Odling-Smee, EU2; Márquez-Ruarte, EU2; Fernandez-Ansola, PDR; Broadman, IBRD

General Arrangements to Borrow—Activation

Staff representatives: D. Williams, TRE; Kuhn, TRE

Operational Budget for June–August 1998— Enlargement

Staff representatives: D. Williams, TRE; Kuhn, TRE

Also Present

IBRD: E.M. Favaro, Latin America and Caribbean Regional Office; S. Michailof, Africa Regional Office; H.G. Broadman, B.R. Pinto, Europe and Central Asia Regional Office. African Department: A. Basu, Deputy Director; G.E. Gondwe, Deputy Director; E. Hernández-Cata, Deputy Director; P. Beauprand, A. Bessaha, M.S. Diop, C.A. François, E. Maciejewski, E. Sacerdoti, N. Toe. European II Department: J. Odling-Smee, Director; J.R. Márquez-Ruarte, Deputy Director; B.J. Aitken, O.P. Brekk, I. Kapur, S.P. Panth, M. Shadman-Valavi, Y. Sun, T.A. Wolf. External Relations Department: S.J. Anjaria, Director; M.W. Bell, D.R. Hawley, G.P. Newman. Fiscal Affairs Department: P.S. Heller, Deputy Director; N.A. Chalk, A.G.A. Faria. Legal Department: W.E. Holder, Deputy General Counsel; H. Elizalde, D.E. Siegel. Monetary and Exchange Affairs Department: W.E. Alexander, K.F. Habermeier. Policy Development and Review Department: J.T. Boorman, Director; J. Ferrán, Deputy Director; A.G.G. Bennett, J. Fernandez-Ansola, M. Fisher, C.G. Muriz, B. Lissovlik, T. van der Willigen. Research Department: M. Mussa, Director and Economic Counsellor; P. Garibaldi, R. Sahay. Secretary's Department: S. Bhatia, P. Gotur, M.J.M. Miller, B.A. Sarr. Treasurer's Department: D. Williams, Treasurer; K. Boese, W.J. Byrne, M.M. Cuc, E. Decarli, L.U. Ecevit, C.A. Hatch, M.G. Kuhn. Western Hemisphere Department: C.M. Loser, Director; D.G. Dunn, J.P. Guzman. Office of the Managing Director: M. Russo, Special Advisor; J.A. Clément, O.J. Evans; Office of Internal Audit and Inspection: E. Brau, Director. Advisors to Executive Directors: J. Jonáš, Luo Y., M.-H. Mahdavian, H. Mori, H. Ogushi, O. Otazú, L. Palei, A.R. Palmason, O. Sein. Assistants to Executive Directors: A. Abdychiev, A.S. Alosaimi, Awang G.G., S.A. Bakhache, T. Belay, J.G. Borpujari, K.S. Brownlee, I.-K. Cho, M.A. Cilento, D.A.A. Daco, J.C. Estrella, H. Hagan, M.A. Hammoudi, S. Hinata, J.K. Honeyfield, H. Javaheri, K. Kask, M. Kell, S.K. Keshava, E. Kornitch, K. Kpetigo, K. Lai, Lu A., F. Mercusa, D. Merino, W. Merz, J. Nemes, M. Nemli, H. Paris, T. Presečan, Qi J., D. Saha, J.N. Santos, O. Schmalzriedt, G. Vigliotti, M. Vismantas, R.P. Watal, P. Winje, A.G. Yakub, I. Zakharchenkov.

1. HAITI—1998 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1998 Article IV consultation with Haiti (SM/98/163, 7/1/98). They also had before them a background paper on recent economic developments in Haiti (SM/98/168, 7/6/98).

The staff representative from the Western Hemisphere Department stated that there appeared to be agreement in principle among the major parties on the way to resolve the electoral and political crisis in Haiti. In the preceding week, President Preval had nominated the current Minister of Education to the post of Prime Minister. Parliamentary approval of that nomination, which in any case was likely to take about two months, was uncertain at the present stage, as some members of the second largest faction in the parliament had already expressed a reluctance to support it.

Mr. Kafka and Mr. Bernal submitted the following statement:

In mid-1996, Haiti embarked on a medium-term economic program which was supported by a three-year Enhanced Structural Adjustment Facility (ESAF). The main objectives of the program were to alleviate poverty, lower inflation, and sustain economic growth through the implementation of financial policies and structural reforms that would enhance macroeconomic stability. The first annual arrangement, which was approved in October 1996, expired without completion of the mid-term review.

In the past year and a half, under very difficult political and economic circumstances, progress toward macroeconomic stability has been made, in part thanks to the implementation of a staff monitored program. The domestic security situation has improved and so have the public finances, while exports and remittances from abroad have increased. The external current account deficit has been reduced significantly, and inflation has moderated. However, output growth has been sluggish. The political situation has adversely affected the implementation of structural reforms, the disbursement of external aid flows, and the recovery of investment.

The progress made toward macroeconomic stability in fiscal year 1996/97 was based on a sharp reduction of the central government deficit to 0.5 percent of GDP from 2.5 percent of GDP in 1995/96. My authorities are committed to keeping the 1997/98 deficit at less than 1 percent of GDP, which will be below that of the original three-year program.

In fiscal year 1997/98, government revenue as a ratio to GDP is expected to drop due to a weakening of tax administration. In order to bolster revenue collection, my authorities are taking action to recover the sizeable fuel tax arrears accumulated during the early part of 1998 and are reinforcing procedures for the payment of these and other excise taxes, while taking other steps to improve tax administration in the customs office and the "large tax payers' unit" of the internal revenue service. Also, since end March 1998 my authorities have put in place a new cash management system and since June 1998 have tightened expenditure authorization procedures to limit monthly government outlays to revenue collections and projected financing. My

authorities have tightened government hiring procedures and implemented physical verification of wage payments to reduce fraudulent payments. Moreover, they intend to continue to resist pressures for wage increases during the fiscal year while reducing the size of the civil service under the recently enacted civil service downsizing (CSD) law.

In 1996/97, external budget support fell by some \$130 million (about 4 percent of GDP) short of the programmed level. However, project assistance picked up as steps were taken to improve project administration and implementation. For 1997/98, donor representatives have indicated that a limited amount of budget assistance could be disbursed in support of the government's efforts at macroeconomic stabilization and structural reform; my authorities are particularly grateful for this assistance in the recent difficult economic and political situation.

In the last two years, substantial progress was made in implementing financial sector reforms. Central bank bill auctions and reserve requirements on foreign currency deposits were introduced, and the reserve requirement on gourde deposits was reduced. The central bank administration was reformed with a one-quarter reduction in employment, the accounting and information systems were upgraded, and foreign exchange operations and reserve management were strengthened. Also, progress was made in tightening prudential norms and banking supervision, with technical assistance from the Fund and the IDB. My authorities are committed to making further progress in this area and, in this context, will begin phasing in next September capital adequacy regulations consistent with international standards. Moreover, steps are being taken to begin restructuring the troubled state banks, with a view to their eventual privatization.

The monetary program for 1997/98 was designed with the objective of reducing inflation—for the time being—to about 12 percent per annum and maintaining constant the official net international reserves. In this context, my authorities have tightened credit conditions mainly through open market operations; the interest rate on central bank bills was raised from 18 percent to 24 percent. In view of the recent decline in inflation, my authorities intend to begin lowering these interest rates, but in doing so they remain committed to maintaining interest rates positive in real terms. At the same time, credit expansion by state banks has been restrained.

On structural reform issues, although the political situation is preventing parliamentary approval of legislation—such as trade reform, budget and expenditure procedures, investment code and direct tax reforms—my authorities intend to continue to make progress consistent with existing legislation. In addition to implementing of the CSD law, the program envisages progress toward the restructuring and privatization of public enterprises, with assistance from the World Bank, the IDB, and USAID. As mentioned above, my authorities also will continue to strengthen supervision and regulation of the financial system and they are committed to restructuring and privatizing of the state-owned banks with technical assistance from the Fund and the IDB.

My Haitian authorities recognize that macroeconomic stability and the implementation of the structural reform agenda are essential to promoting durable economic growth and improving living conditions. In this context, my authorities are committed to maintaining prudent fiscal and monetary policies, that allow the gradual reduction of inflation, while every effort is being made to find a democratic and reform-oriented solution to the current political impasse. In the meantime, they intend to continue making progress in structural areas consistent with existing legislation. In support of their efforts, my authorities have requested that discussions begin over the next few months on an economic policy framework for 1998/99 that could facilitate continued donor assistance and the start of discussions on the second annual ESAF arrangement once a new government is installed.

Finally, on behalf of my Haitian authorities I wish to express my gratitude to the Fund for the support provided to Haiti.

Ms. Turner Huggins made the following statement:

I thank the staff for a helpful set of reports and for its candid depiction of the political crisis in Haiti. It is heartening that the Haitian authorities have continued to plod along with complex reforms despite their impossible political situation since the middle of 1997. The staff and the authorities are to be commended for their ongoing dialogue and achievements during this period. In particular, I was encouraged by the fact that agreement on a staff-monitored program was reached, and that most of the structural benchmarks and prior actions were met, as noted in Table 9.

The authorities have demonstrated their commitment to structural reforms in a number of ways, including the civil service downsizing law, the public enterprise modernization process, the improvements in financial sector legislation, the central bank reform, and the restructuring of and intervention in the state-owned banks. While much remains to be done in the fiscal area, we appreciate the difficulty involved in executing a number of draft laws, which remain with parliament. Nevertheless, Haiti is an example of successful collaboration between its multilateral donors.

This chair strongly supports the authorities' request for discussions to begin on an economic policy framework for fiscal year 1998/99 that could form the basis for eventual dialogue on the second annual ESAF Arrangement once a new government is installed. We urge the international community to remain positively engaged with the Haitian authorities during this difficult period to ensure sustained momentum for economic reforms, without which a successful democratic process is unlikely. In this regard, we commend the Fund for maintaining its high-level presence in Haiti, with technical advisors, a resident representative, and staff visits. Given the limited administrative capacity in Haiti, we view the provision of technical assistance as one of the major contributions the Fund can make at this time.

I am in broad agreement with the staff's assessment, and sympathize with the political constraints as outlined by Mr. Kafka and Mr. Bernal. I note

that in the public enterprise sector, a number of important decisions cannot be acted upon because they require the signature of the Prime Minister. Is there no provision in the law that would allow these decisions to go forward in the absence of the Prime Minister?

Perhaps the staff could outline the hurdles that need to be overcome, and the risks involved in, the resumption of the ESAF Arrangement, and what the timetable is in that respect. Also, I am interested in the staff's view of the seriousness of the authorities about attaining the program targets, and whether they have a sense of urgency about getting the ESAF Arrangement back on track.

The staff says that Haiti needs to address with urgency structural reforms to lower domestic production costs, raise productivity, and bolster competitiveness in the tradeables sector. Perhaps the staff can clarify what is meant by that, given that wages—a major component of domestic costs—have declined in real terms for many years; the real wage at present is less than 20 percent of the real wage in 1981.

The changes in the financial sector and the central bank are both encouraging and bold. We welcome the lowering of the reserve requirements on domestic currency deposits and the introduction of reserve requirements on foreign currency deposits, although the differential is still too wide, given the large amount of dollarization in the economy.

The staff referred to the fact that several development institutions and credit unions fall outside of the supervisory net of the central bank. In light of the concerns about private sector credit growth, perhaps the staff could comment on the number of institutions that are outside of the supervisory net, and what, if any, steps are being taken to bring them within it.

I encourage the continuation of technical assistance to Haiti, especially in the fiscal and statistical areas, where the needs seem to be greatest.

Mr. Schneider made the following statement:

Before moving on to the particulars of Haiti's review, I would like to take this opportunity to thank the staff for its excellent work. Haiti's political situation has made the formulation of an economic stabilization and reform program difficult. The staff's efforts to work within these political constraints are admirable, and have borne fruit in the form of a staff-monitored program with some important prior actions that I hope will lay the groundwork for a new ESAF Arrangement. This program has helped to hold the economy together while pursuing structural reforms as far as possible, and we believe it deserves support.

These favorable developments notwithstanding, the Haitian economy continues to be extremely fragile. Growth continues to be anemic, inflation hovers in the mid-teens, external balances are fragile, and social indicators are

extremely slow, with a per capita GDP that makes Haiti the poorest country in the Western Hemisphere.

On fiscal policy, it is essential that the authorities continue to operate within the cash management system, pursue work on both the revenue and expenditure sides, and correct the slippage in the central government deficit target. We strongly support efforts to computerize the customs administration and place tighter restrictions on the granting of tax exemptions. These and other measures to improve tax administration will be crucial if the authorities are to raise total revenue from its current very low level of only 8 percent of GDP, and if there is to be any room to lower interest rates in the near term.

On the expenditure side, we welcome the formal institution of a cash management system in the absence of a formally approved budget. Containment of wage-related expenditures is also key for short-run fiscal management, and we strongly support the authorities' commitment to resist pressure to once again raise teachers' salaries, this time by 32 percent. Aside from the immediate fiscal costs, it is also important not to allow wage-related spending to crowd out other education-related expenditures, such as on textbooks and facilities.

Monetary policy remains prudent, and tight credit seems warranted, given the continued high levels of inflation and the need to keep real interest rates positive. We concur with the staff assessment that the government should carefully calibrate any softening of monetary policy with fiscal consolidation. We were curious about the private sector's concerns regarding loan portfolios, however. Should there not be room to lower interest rates in the next few months? We would welcome any elaboration by the staff on this point.

On structural reform measures, the staff-monitored program focuses appropriately on three central pillars of structural reform: civil service downsizing, privatization, and financial sector reform. Civil service reform is absolutely critical, and we welcome the publication of the civil service downsizing law in mid-May. We recognize that this is a highly sensitive area of reform, and we welcome both the authorities' determination to proceed and the donor support that is being made available to cover severance payments and one-time costs. It will be critically important, however, to ensure that civil servants who leave one agency are not then reemployed by another. In this context, we support the staff and the authorities' attention on facilitating employment in the private sector.

Privatization must also be pursued, as far as legislative constraints will allow, and the extremely poor quality of public utilities and services is reason enough to pursue new management. In this context, we welcome the authorities' agreement on a modality for restructuring and, we hope, privatizing the electricity company. We also noted that initial work has been started on the privatization of the port, airport, and telephone companies. We were curious about the potential time frame for either privatizing these companies or bringing them under a management contract.

We also welcome the financial sector reform plans, in particular the replacement of the management of the Banque National du Credit with an intervention team. We also support the authorities' desire to restructure and/or privatize the state-owned banks, and would encourage the provision of technical assistance in this area. The quality of bank assets has deteriorated over the past year as overdue loans have increased. Simultaneously, we would expect a surge in private sector borrowing if the central bank reduces interest rates. To ensure the health of the banking system, we would steady implementation of prudential guidelines and capital adequacy ratios.

Finally, effective governance sets the tone for an enabling business environment. This means improving tax and customs administration, eliminating fraud, upholding government accountability and transparency, and respecting the rule of law through a well-functioning and accountable judicial system.

While we support the general direction of the staff-monitored program, we recognize that it is merely a holding action. Haiti's economic potential continues to be hampered by the lack of a stable political environment and the kind of deep-seated structural issues that can be addressed only in the context of an ESAF program. The staff-monitored program now in place lays the groundwork for an ESAF Arrangement, but it will need to be implemented steadfastly by the authorities. As the staff has pointed out, there is a significant risk of slippage on a number of fronts, and we would urge the authorities to be vigilant on these. The major obstacle to deeper reforms and the building of a solid foundation for long-term economic growth is the political impasse. The naming of a candidate for Prime Minister gives us reason for cautious optimism, and we urge the Haitian government to finally resolve the political impasse.

Mr. Rodriguez made the following statement:

First, like previous speakers I would also like to commend the staff for providing a thorough and candid analysis of the Haitian economy. It is unfortunate that the political crisis interrupted the implementation of the first annual arrangement under the ESAF, affecting aid flows and economic activity. Nevertheless, despite the political turmoil, in a commendable effort the authorities have been able to maintain prudent macroeconomic policies, which have contributed to achieve significant reductions in inflation, the current account deficit and the fiscal deficit.

The staff have pointed out the political situation as the main obstacle for the adoption of a program of stabilization and structural reform. In general, this could be true about many other countries, but its recognition by the staff is a clear indication of the difficulties faced by the government. The staff's emphasis on a political settlement through a democratic process is also appropriate. Although this could take some time to be achieved, it is the only way to ensure an equitable and sustainable solution. Meanwhile, some progress may still be achieved through the staff monitored program with the support of the international community.

The macroeconomic objectives for the FY 1997/98 seem adequately ambitious and the approach towards the implementation of structural reforms is pragmatic, given the current political restrictions. In general, I share the views expressed by the staff in their appraisal and I would like to add some comments.

In the fiscal area, in spite of the political circumstances, last year's results were much better than expected. In particular, the strengthening of tax administration, which contributed to a significant increase in revenues is commendable. In contrast, the recent weakening of tax administration is disappointing and somewhat surprising. Apparently, part of this may be overcome in the second semester, but it is also noted that even in the high growth scenario the tax revenue/GDP ratio reached last year will not be achieved again until the year 2000. Staff's comments on this issue will be welcomed.

On the expenditure side, the fiscal target set for this year apparently will require some expenditure restraint as well. The staff have mentioned some measures, which should be adopted, such as the ambitious civil service downsizing and the tougher hiring procedures. However, given that the current fiscal situation is not exactly pressing (in fact, it is better than had been anticipated in the original three-year program), expenditure restraint should not lead to delays similar to those of last year, which are not real savings. Besides, there are areas that deserve more attention. Being the poorest country in the continent, Haiti clearly needs to increase (not just protect) its spending on health and education, enhancing its effectiveness as well.

The scaling back of capital outlays, which is a form of postponement, raises some doubts. The staff have the importance of public infrastructure by arguing that the country's competitiveness depends more critically on improving roads, ports, airport, utilities and services than on restoring a certain real exchange rate level. Perhaps, these needs have been somehow taken into account in the medium-term high-growth scenario, given the larger fiscal deficits after 1999. The staff may want to elaborate further on what the assumptions are and what the policies might be in this area.

After following a looser-than-programmed monetary policy, the central bank adopted this year a more restrictive stance, pushing interest rates up. It is worth emphasizing that the looser monetary policy resulted from a lack of compensation of the sharp decline in reserve requirements. In general, switching to indirect instruments of monetary policy is welcome, because of their flexibility and because high reserve requirements are an implicit tax in the banking system, affecting the savings/investment decisions. However, open market operations are best suited for marginal interventions in the money market, not necessarily for the kind of interventions that would be needed to compensate large reductions in reserve requirements. Hence, as suggested by the staff, remunerating the reserve requirements could be an alternative to implementing further reductions in the reserve requirements. It would have a positive effect on the banks and the financial system, without risking the control over monetary aggregates. Nevertheless, there appears to be some

concern about the quasi-fiscal cost, which is somewhat puzzling, given the disposition to reduce reserve requirements. If an equivalent reduction of the reserve requirements were to be fully offset by open market operations, it would have the same quasi-fiscal cost of remunerating reserve requirements.

In the context of a relatively healthy the financial system, the progress in tightening prudential regulations and in strengthening banking supervision is encouraging. However, the banks' loan concentration and low capital could pose a serious risk. Furthermore, the relative high degree of loan concentration also implies problems of access to credit and other banking services by the population at large, which have not been effectively addressed by the state-owned banks, given their insolvency. In this connection, the authorities' intentions to introduce stronger capital adequacy requirements and to restructure or privatize the state-owned banks, as well as the increased competition among commercial banks, are welcome as they should lead to a sounder financial system.

With these remarks, I would like to wish the Haitian authorities all the success in their challenges ahead.

Mr. Fremann stated that he welcomed the staff-monitored program. Assessing the recent performance of the Haitian economy was not easy in view of the difficult political situation. Growth had been sluggish despite the containment of the budget deficit, the moderation in the rate of inflation, and some structural reforms, in particular in the financial sector. The slow pace of growth, in parallel with the continued increase in population growth, meant that poverty was unlikely to be reversed.

The authorities deserved credit for taking vigorous actions to contain the fiscal deficit, but it was to be hoped that those would not be detrimental to social sector expenditures, Mr. Fremann observed. He was also worried about the potential wage increases in the public sector, especially in view of the lack of a more serious reform of the civil service.

The external account had benefited indirectly from economic growth in the industrial countries, through emigrants' remittances, which he welcomed, Mr. Fremann continued. At the same time, the improvement in the current account was having the effect of alleviating the pressure on the authorities to make political reforms.

The Fund and other institutions had provided large-scale technical support to Haiti, Mr. Fremann concluded. Such support was essential to improve Haiti's institutional capacity, but it was likely to be undermined by the inability of the authorities to carry out major reforms. There was clearly a risk that the authorities would continue to rely on technical support from donor institutions, rather than on developing technical competencies themselves.

Mr. Singh made the following statement:

We would first like to express our concerns about the continuing unsettled political situation in Haiti, which undermines the achievements of the reform efforts initiated since 1996 and jeopardizes recovery prospects. Under such conditions, we agree with the staff that the main challenge for Haiti is to

reach a political settlement as soon as possible that facilitates the implementation of sound financial policies and promotes structural reforms.

We regret that the deterioration of the political situation in the second half of 1997 did not allow the completion of the mid-term review under the first annual ESAF arrangement and that the 1996/97 program fell short of expectations. This is especially unfortunate since efforts aimed at strengthening public finances had started to pay off, notably in the area of the tax collection system.

Taking into account the increasing vulnerability of the economic situation of Haiti and the increasing incidence of poverty, we welcome the decision of the authorities to consider a staff-monitored program covering the fiscal year 1997/98 in order to maintain financial discipline. There is a clear need for an emergency program aimed at assuring macroeconomic stability and at avoiding a further collapse of the economy. In addition, maintaining a policy dialogue with Haiti could stimulate local political awareness of the need for finding a solution to the current crisis.

This being said, however, we have serious concerns about the overall credibility of the program under the current circumstances, especially in the area of structural reforms. As noted by the staff, the economic environment remains extremely fragile and the political situation may continue unsettled for quite some time. A number of important legislative measures are just languishing in parliament and there are clear risks of slippages in tax collection, government wage policy, expenditure restraints and civil service downsizing.

In particular, we question the tight time frame allocated to the downsizing of the civil service. Given the experience of many other countries under Fund programs, we have serious doubts whether such an important reform implying early retirement, separation or retraining of at least 5000 civil servants can be carefully carried out by the end of September. Civil service reforms are known to be politically difficult. Moreover, they are essential not only for fiscal consolidation, but also to improve government efficiency, which requires much more than a quick downsizing. In such circumstances, we have some doubts whether the required \$12 million of external grants can be mobilized to cover the very high one-time costs associated with this reform.

To conclude, we would like to urge the authorities to take all necessary actions to bring about a rapid solution to the current political paralysis. Without solving the crisis in a way to enable both executive and legislative branches of the Government to resume work, there is simply no scope for far-reaching reforms and poverty alleviation.

The staff representative from the Western Hemisphere Department stated that an increase in tax collections in Haiti was unlikely to be achieved before the year 2000 because such an increase depended on improved tax administration, which would take some time. In particular, the legal framework for tax collection needed to be strengthened, and that would require parliamentary approval. Also, the tax collecting agencies would need to be

restructured, which was likely to be a difficult and time-consuming process. Nevertheless, scope existed for increasing revenues by reducing tax evasion.

The staff was concerned about the effect of very high real interest rates on the banking system and on the quality of the banks' loan portfolios, and in that context, the staff had asked the authorities about the prospects for a reduction in rates, the staff representative continued. The authorities had said that they would be moving to reduce the interest rate on central bank intervention instruments over the coming few weeks. However, any loosening of monetary policy would need to be accompanied by a tightening of fiscal policy, and in that respect, the authorities had indicated that they remained committed to the program targets on the fiscal sector for September 1998, and that they would take actions to strengthen tax collections.

The minimum wage was not a good indicator of wage developments in the economy as a whole, and should not be taken as a key indicator of the economy's competitiveness, the staff representative considered. There had been a substantial real exchange rate appreciation, which the staff saw as a better indicator of total cost pressures in the economy. Costs were high in Haiti, especially in the tradable sector, where transportation costs were extremely high. Port costs were among the highest in the Caribbean, and the roads were in a terrible state. Erratic electricity supplies, with many service interruptions, forced companies to purchase their own—costly—electricity generators. The telecommunications system was poor, with a paucity of lines and service interruptions commonplace. The political crisis had forced many highly qualified Haitians to emigrate, leading to a shortage of skilled labor at present. While wages had declined in recent years, so had labor productivity. While there was potential for increasing exports, as evidenced by the strong growth of assembly sector exports, and competitiveness did not seem to be a major issue at the current juncture, the staff continued to be concerned about the issue.

The favorable medium-term scenario envisaged increasing donor and creditor support for infrastructure investment, in particular for road network rehabilitation and expansion, and the privatization of the public enterprises, including the telephone and electricity companies and the port facilities, the staff representative explained. The scenario also envisaged an increase in donor support for the social sectors, which the staff hoped would begin to alleviate the lack of skilled labor in Haiti—a major constraint—in the medium to long term.

The signature of the prime minister was required to close enterprise privatization transactions under the public enterprise restructuring law, the staff representative confirmed. While under certain circumstances the president could close a transaction by decree, that carried significant legal and political risks.

Nonbanks and credit unions did not constitute a large part of the financial system in Haiti, the staff representative pointed out, and at present the nonbanks were not covered by the bank supervisory net. However, as banking system supervision began to tighten over the succeeding few years, there would be an incentive for a shifting of financial intermediation resources to nonbanks. It was for that reason that a draft law on financial intermediaries was being prepared, with Fund technical assistance. Under that law, the central bank would take over the regulation and supervision of nonbanks.

The resumption of the ESAF Arrangement depended upon the continuation of the reform process and political support for the reforms, both by the administration and

parliament, the staff representative concluded. At the current juncture, it was clear that the electoral crisis was the chief impediment to the reform process.

Mr. Kafka stated that he was grateful to his colleagues for their comments, which he would relay faithfully to the Haitian authorities. It was clear that the Haitian economic situation was not an easy one. At the same time, it could not be denied that considerable progress had been made, particularly in the direction of macroeconomic stability, in recovering sizable tax arrears during the early part of the year, and the steps to improve tax administration. The institution of the new cash management system had also been important. The Fund needed to take seriously the government's commitment to strengthen further the continuing initiatives.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the progress made toward macroeconomic stability over the past year under very difficult political and economic circumstances. They noted that along with the improved domestic security situation, public finances have strengthened and exports and remittances from abroad have increased. However, Directors expressed concerns over the adverse impact of the continuing political crisis on the implementation of structural reforms, the disbursement of external assistance, and the recovery of output. In this connection, Directors underscored the importance of reaching, through a democratic process, a political settlement that would facilitate the implementation of sound financial policies to lower inflation further and promote structural reforms to support sustained economic development and poverty reduction.

Directors emphasized that the key issue in the short term is the establishment of macroeconomic stability. In this context, they were encouraged by the progress made thus far in the implementation of a staff-monitored program for fiscal year 1997/98. Directors noted, however, that the economic situation remains very fragile and there are risks of slippages in the fiscal and structural areas. They stressed that steadfast implementation of the staff-monitored program would help mobilize donor support and facilitate an early resumption of discussion on the second-year ESAF, once the new government is installed.

Directors urged the authorities to reinforce steps to secure the attainment of the program's target for the public finances, which would be essential for lowering inflation, taking pressure off interest rates, and supporting the expansion of investment and output. On the revenue side, Directors encouraged the authorities to step up efforts to reduce tax arrears, improve tax and customs administration, and tighten the granting of tax exemptions. They also stressed that institutional strengthening of the tax and customs agencies was needed to bolster revenue collection in the medium term. On the expenditure side, they urged the authorities to implement procedures to contain government expenditure to estimated revenues and available financing as envisaged in the program. They stressed the importance of resisting pressures for substantial wage increases, eliminating fraudulent wage

payments, tightening the procedures for the hiring of government employees, and cutting capital outlays with low returns, while still maintaining adequate budgetary allocations for social spending.

Directors welcomed the authorities' prompt action to tighten credit conditions through open market operations and to restrain credit expansion by the state-owned banks. They urged the authorities to continue their restrained credit policy until there are clear signs that fiscal adjustment is taking place and inflation is declining as programmed.

Directors emphasized the importance of implementing policies aimed at lowering domestic production costs, raising productivity, and bolstering the competitiveness of the tradeable sectors. In this regard, Directors stressed that progress in the implementation of Haiti's structural reform agenda and improved governance, especially in respect of enforcement of the tax code and reform of the judiciary, is essential to promote sustainable economic growth and improve living conditions, particularly for the poorest. They urged the authorities to adhere to the staff-monitored program's targets for downsizing the civil service (essential for fiscal consolidation), and to implement sectoral policies aimed at improving government efficiency in the delivery of essential services, such as security and justice, health and education, and infrastructure rehabilitation and maintenance. Directors noted that the improvement of management and administration of the public investment program is urgently needed to speed up the execution of the public investment projects.

Directors encouraged the authorities in their efforts to seek rapid progress in the restructuring and privatization of the main public enterprises, as well as the approval of legislation to strengthen public finances. They also emphasized that, to strengthen the health and efficiency of the financial system, it is essential that the authorities make rapid progress in the restructuring of the troubled state-owned banks, the phasing-in of financial sector regulations consistent with international standards, and the strengthening of supervision over financial intermediaries. Directors urged the authorities to redouble their efforts to upgrade the quality of monetary, fiscal, external, and real sector statistics with technical assistance from the Fund and other donors.

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

2. CENTRAL AFRICAN REPUBLIC—1998 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1998 Article IV consultation with the Central African Republic and the Central African Republic's request for arrangements under the Enhanced Structural Adjustment Facility (ESAF) (EBS/98/117, 7/10/98). They also had before them a statistical annex (SM/98/185, 7/14/98), together with a policy framework paper for the period 1998–2000 (EBD/98/50, 6/1/98).

The staff representative from the African Department noted that the United Nations Security Council had extended the mandate of the United Nations Mission in the Central

African Republic (MINURCA) peacekeeping force to October 25, 1998. Elections were to take place on September 20, followed by a second round of balloting on October 11, and the official results were to be announced on October 25. The staff therefore considered that political developments were on track.

Mr. Barro Chambrier made the following statement:

My Central African Republic authorities would like to thank management and the staff for the assistance provided to them in the preparation of this program, for which they are requesting Fund support. They are in broad agreement with the policy recommendations contained in the staff report.

As Directors will recall, the implementation of the program, supported by the Stand-By Arrangement approved by the Board in March 1994, met with serious difficulties. These were mainly related to weaknesses in the financial management and political uncertainties. The authorities' efforts to introduce corrective measures were interrupted by social unrest and mutinies. As a result, through the first half of 1997, the economic and financial performance deteriorated sharply and the reform process was thwarted.

In the aftermath of these events, the authorities have strengthened their efforts at national reconciliation and have renewed with their structural reform agenda. Indeed, the return of peace and normalcy was facilitated by the international peacekeeping effort, the establishment of a broad-based government and the organization of a conference on the national reconciliation. Reflecting these efforts, the security situation has improved considerably and the institutional framework of the government's structural adjustment program has strengthened. In the event, Central African Republic's ownership of the program was reinforced through the revitalization of the Interministerial Committee and its Permanent Technical Committee. Growth and inflation performance also improved significantly in 1997, due to the resumption of economic activities. However, with the erosion of confidence of investors and donors, the country's external position weakened. On the fiscal front, the disruption of the public administration services, compounded with weaknesses in revenue administration and collection, contributed to a severe cash-flow crisis, forcing the government to accumulate domestic and external arrears.

It is in this respect that the authorities, in close collaboration with the staffs of the World Bank and the Fund, have updated their medium-term strategy and set specific objectives over the period 1998-2000 to address the major challenges facing their country. Consistent with this strategy, the program for 1998 seeks to achieve a real GDP growth of 5.5 percent, an inflation rate of 2.6 percent, and an external current account deficit of 6 percent of GDP. The attainment of these objectives is critical to reduce unemployment and alleviate the pressing issue of poverty. To this end, the authorities are determined to implement sound macroeconomic policies and introduce bold structural reforms forcefully. The strong prior actions already implemented are an indication of my authorities's resolve.

In the fiscal sector, the authorities are mindful that macroeconomic stabilization hinges on the pursuit of a vigorous fiscal consolidation effort. This is essential to promote public savings in order to reduce the debt burden and the government's reliance on exceptional external assistance. Therefore, the authorities have set ambitious, but realistic, fiscal targets, mainly to shift the primary fiscal balance from a deficit of 0.6 percent of GDP in 1997 to a surplus of 1.4 percent of GDP in 1998. To this end, the 1998 budget called for a major effort to strengthen the efficiency of the tax and customs administration, recover tax arrears and reduce exemptions. In addition, to improve the monitoring of the program's revenue objectives, quarterly revenue targets were assigned to the revenue agencies. As highlighted in Box 3 (p. 13) in the staff report, the measures already taken by the authorities are in line with the recent FAD recommendations and augur well for a significant improvement in the revenue performance.

Regarding the public expenditure, it is important to note that the Government has set its ceiling at CFAF 102 billion in 1998 (or about 16 percent of GDP), while allocating larger resources to the priority sectors of education, health and infrastructure investments. Thus, to free additional resources for the funding of these priorities, a tight control is kept on nonpriority expenditure of goods and services, and transfers. The wage bill will also be reduced by about 3 percent in real terms, mainly through adherence to a prudent wage policy, the downsizing of the civil service and the restructuring of the armed and security forces. In this connection, all positions in both sectors will be maintained at about 19,500 at end-1998. Furthermore, to address the issues of transparency and accountability in public finance management, extra budgetary expenditures were eliminated and all government financial operations centralized at the Ministry of Finance and Budget.

As regards the arrear payment problems, the authorities will endeavor to find appropriate solutions. The audit of the domestic arrears is well advanced. Following its completion in September 1998, the authorities intend to draw up a program for an orderly settlement, including through the issuance of long-term treasury bonds and cash payments over time as the budgetary situation improves. They are aware that the settlement of salary arrears is vital to bring about confidence in the civil service. The authorities also intend to eliminate the outstanding external payment arrears this year, through cash settlement and debt relief. It is important to stress that they maintain close contact with their creditors and will continue to give priority to the Fund's preferred creditor status.

Within the BEAC monetary area, the authorities will continue to support a monetary policy geared at keeping inflation at moderate levels and strengthening the international reserve position. To this end, the growth of the money supply will be limited, while access to credit by the private sector will be slightly increased. This policy action will be facilitated by increased reliance on indirect instruments. In addition, the authorities will continue to support the prudential rules of the regional banking supervision agency (COBAC), in order to rebuild a sound banking system and enhance financial intermediation.

On structural reforms, the authorities have taken bold steps and are determined to increase their efforts in the key areas. First, following the completion of the initial phase of the privatization of the state-owned commercial banks, the authorities have adopted a timetable to restructure or privatize BICA, UBAC, and BPMC, and to complete the liquidation of four other banks that have ceased activities. Second, the privatization of the nonfinancial public enterprises will be accelerated with World Bank assistance. To that effect, a single public agency responsible for all privatization operations was established last June, with detailed measures to be implemented over the period 1998-2000. This concerns particularly the divestiture of the oil company (Petroca) and the electricity company (Enerca), as well as the partial sale of the state shares in the telecommunications sector (SOCATEL). Regarding Petroca, the government will withdraw from the distribution component by end-September 1998 and complete the privatization by 2000. Third, steps are being taken to improve the institutional and legal environment of the private sector. The emphasis is placed on the reactivation of the Forestry Code, the revision of the Mining Code and the simplification of the investment procedures. Fourth, a unified civil service roster has now been established, with a view to strengthening personnel and payroll management.

With regard to debt sustainability, based on the available data, the staff report indicates that the Central African Republic would not qualify under the HIPC Initiative. However, while it appears that the ratio of NPV of debt-to-export would decrease below 160 percent by 2001, in fiscal terms, the ratio of NPV of debt-to-government revenue, projected at 335 percent, will remain well above the benchmark of 280 percent. Clearly, the Central African Republic's debt would continue to pose major constraints on the development of the country's large potential. Notwithstanding the commitment of the authorities to prudent debt management, external financing on concessional terms will be needed for some time.

In conclusion, the mutinies of 1996-97 have adversely affected economic activities and the public finances. However, my Central African authorities remain committed to the economic reform process. The program for which they are requesting Board support will give them an opportunity to address the country's major economic and social problems, while normalizing relations with their creditors. It is my authorities' expectation that the social consensus will strengthen so as to boost the reform process. The task ahead of them is more challenging, and adequate financing from the donors is critical to the success of this adjustment process. Technical assistance is also needed in the areas of macroeconomic capacity building, tax reforms, budget operations and statistics development.

Extending his remarks, Mr. Barro Chambrier underscored the extension of the MINURCA mission as a positive step. The authorities intended to seize the opportunity to consolidate their peace efforts.

Mr. Fernandez made the following statement:

I am pleased to see that the Central African Republic, after having faced considerable difficulties over the past years, is on the path of recovery. The political and security situation has stabilized, thanks to the commendable efforts accomplished by the authorities and the international peacekeeping force (MINURCA). Emergency adjustment measures have been introduced during the first half of 1998, and a medium-term strategy was established in close collaboration with multilateral institutions. Performance in recent months has been satisfactory and encouraging. Clearly, there is now an opportunity to go ahead.

I share the staff appraisal which considers the authorities' program for 1998-2000 to be strong and credible. The ambitious fiscal consolidation and privatization program deserves to be supported by the ESAF. All the agreed prior actions have already been implemented in a timely manner and important achievements are foreseen as of 1998. Consequently, I can support the proposed decision.

Like everyone, I am aware that the situation of the Central African Republic remains fragile and that the program for 1998 is a real challenge. In this regard, I would like to focus my comments on three sensitive issues: the fiscal performance, the structural reform agenda and the settlement of external arrears.

First of all, strengthening the fiscal position is obviously at the core of the adjustment program for this year. The objectives of achieving a primary budget surplus of 1.4 percent of GDP and reducing the overall fiscal deficit suppose rigorous and continuous efforts, both on the revenue and expenditure sides, as indicated in the revised budget for 1998. Given the tight treasury cash flow situation, there is no room for slippages and a close monitoring will be essential. In particular, the authorities have to press ahead early with the removal of exemptions, consistent with the regional reform program in the tax and customs areas. An enhanced transparency in public financial management will also be a key factor and I welcome the decisions already taken by the authorities to improve performance in this area. Such efforts must be sustained. 1998 is an election year and calls for increased vigilance.

Turning now to the structural front, the agenda is substantial, as it must be within the context of an ESAF support. In the short term, it is crucial to complete the privatization of the distribution of petroleum products (PETROCA). After that, the cases of the telecommunications company (SOCATEL) and the electricity company (ENERCA) will also have to be addressed. I am confident in the authorities' resolve to proceed with all due speed on this divestiture process, which implies difficult negotiations. Concerning the restructuring of the banking sector, I note that initial steps were undertaken and that the authorities intend to actively pursue the financial sector reform, with the guidance of the regional banking supervision agency (COBAC). While reestablishing a sound banking system is indeed essential, I welcome their commitment in this area. Overall, I emphasize that the full

implementation of the envisaged structural measures will be critical to send a positive signal to the private sector and to the donor community.

Concerning the external debt, the settlement of the Central African Republic's arrears is to be completed by end December 1998. This settlement will take place within the context of a very tight treasury cash flow management plan. I agree with staff that the external payments arrears strategy would be unavoidably jeopardized if delays occurred in implementing the scheduled reforms. The authorities have to be fully aware of this constraint. But it must also be underlined that providing the expected external financial assistance in a timely manner will be as well a crucial condition for a successful implementation of the program. In other words, concerted efforts from all partners involved in the program are required at each step. France is ready to do its part.

Mr. Jadhav made the following statement:

Our chair would like to compliment the Central African Republic authorities for their renewed commitment to the economic reform process which, in the recent years, has been adversely affected by military mutinies and social unrest. Efforts at national reconciliation, revitalization of the Interministerial Committee and the strong prior actions already implemented by the authorities have considerably strengthened the institutional framework for structural adjustment. Our chair, therefore, fully agrees with the contention in Mr. Barro Chabrier's helpful buff statement that the proposed program will give the Central African Republic authorities an opportunity to address the country's major economic and social problems, while normalizing relations with her creditors.

We broadly agree with the thrust of the staff report and the overall macroeconomic strategy and objectives for 1998-2000 presented therein. We would like, therefore, to highlight only a few issues partly for emphasis and partly seeking clarifications.

The Central African Republic is in most unenviable situation as far as social and demographic indicators are concerned. Details provided in Appendix V (p. 64) of the staff report are exceedingly sketchy; moreover, they offer no cross-country perspective. A cross country comparison based on the data provided by World Development Report and Human Development Report reveal some distressing facts:

Life expectancy at birth in Central African Republic placed at 48 years (in 1995) was lower than even that of the (weighted) average for sub-Saharan Africa which is placed at 52 years.

Infant mortality rate (per thousand live births) in Central African Republic placed at 98 (in 1995) was higher than even that of the (weighted) average for sub-Saharan Africa.

These indicators, along with the results from 1998 UNDP study revealing that as much as two-thirds of the population in Central African Republic lives below the poverty line, clearly demonstrate the formidable tasks that the Central African Republic authorities would have to address with utmost urgency.

Not all the ills of the Central African Republic economy could legitimately be attributed to social and political upheavals. In fact, the Stand-By Arrangement of 1994 had veered off-track well before the military mutinies of 1996 and 1997, mainly on account of policy slippages. While we are encouraged by the resoluteness shown by the authorities of late, we would like to emphasize that there is no room for complacency. The attainment of the specific objectives laid down in the medium-term strategy are critical for alleviating poverty and reducing unemployment, without which the social stability in Central African Republic is likely to remain fragile.

Going by the track record since 1992, the money-output-prices relationship in Central African Republic is somewhat perplexing: monetary expansion has ranged between -7.7 percent in 1997 to as much as 78.5 percent in 1994; during the program period i.e. 1998-2000, while monetary expansion would be accelerated, the output growth as well as the inflation rate are expected to remain fairly steady. This raises at least two questions: what is the implied real income elasticity of demand for money? Is the underlying money demand function inherently stable? We would welcome staff comments on these issues. With these remarks, we support the proposed decision and wish the authorities continued success in their policy endeavors.

Mr. Melese d'Hospital made the following statement:

I thank the staff for the comprehensive set of papers and for its diligence in assisting the authorities to assemble the ambitious program we are discussing. Clearly, the Central African Republic is an example of a country where the Fund staff has had a strong and distinctly positive impact. This is something we can all be proud of. I agree with the views of the staff and Mr. Fernandez.

I join Mr. Barro Chambrier in commending the authorities' demonstrated strong commitment to start off on the right economic foot, evidenced in the program before us. Of particular importance are their *commitments to restructure and/or privatize the BICA, UBAC, and BPMC*, liquidate the four other inactive banks and, with World Bank assistance, accelerate privatization of nonfinancial public enterprises. Such efforts will be crucial in rebuilding investor confidence following recent social disturbances.

I reiterate that continued efforts toward national reconciliation will be absolutely vital to progress in other areas. In light of this, the announcement regarding the elections is welcomed.

Ms. Patel made the following statement:

The recent political and social instability in the Central African Republic definitely had a devastating effect on the country's economic performance. With the normalization of the situation, the country has now a good opportunity to strengthen the process of economic reform, building on earlier progress and restore investors' confidence. The corrective measures initiated already in 1997 have certainly contributed to reverse the economic and financial deterioration, thus paving the way for negotiating the proposed ESAF arrangement.

The program has broadly set the right tone for the future direction of the economy by emphasizing the need to restore financial viability and for an intensified approach to structural reforms, while paying due attention to strengthening macroeconomic management and institutional capacity. However, given the recent decline in per capita income, more efforts to enhancing the growth potential of the economy would have been important, as higher growth rates are needed to facilitate the task of reducing unemployment and poverty.

Maintaining a prudent financial stance is fundamental to support the growth and stability objectives set in the program. In this regard, the pursuit of highly restrictive fiscal policy is expected to yield a primary surplus for the first time since the early 1990s, representing an important step for faster promotion of public savings. However, given the low revenue/GDP ratio, the authorities should be well advised to take additional measures to enhance revenue performance, essentially, by improving the effectiveness and efficiency of tax administration and eliminating exemptions, among other measures.

The priority given to restraining the growth of expenditure and allocating larger outlays to social sectors and infrastructure investments is also an important feature of the program. The Central African Republic's social indicators remain very weak, and increased public investment in these sectors is clearly indispensable for higher and sustainable economic growth. However, as the authorities' ability to provide adequate outlays to such sectors is constrained by low levels of public savings, concessional external financing will be needed to complement the domestic efforts in this area.

Credible efforts are being made to further liberalize the economy and to facilitate the promotion of private sector development. In particular, the pace of privatization has gained momentum and major reforms are expected to be carried out in the financial sector. In this context, we wonder if any measures are being contemplated to promote nonbank and local credit institutions to provide financing to small businesses as they have an important role to play in enhancing the growth potential and creating job opportunities.

Finally, we hope that a strict adherence to the program targets will be supported by adequate external financial assistance. With these few remarks, we support the proposed decision and wish the authorities every success in meeting the challenges ahead.

Mr. Fujii made the following statement:

I welcome this opportunity to discuss the request for an ESAF Arrangement by the Central African Republic. It is encouraging to see that the authorities have restarted their reform process, are implementing all prior actions and now agree with the staff on a medium-term economic adjustment framework. While I recognize that the authorities face remaining political uncertainty and difficult economic conditions in launching the first step of reform, I hope they will implement the program with continued strong determination. I support the thrust of the staff appraisal and the proposed decision.

I stress the importance of the authorities continuing their best efforts to achieve durable political and social stability, which is a necessary condition for pursuing economic reform. I encourage every effort in this regard. In light of the severe economic situation and increasing poverty, there is no time for delay.

The poor track record is of concern, as the Stand-By Arrangement which was approved in 1994 went off track shortly after its approval because of fiscal and structural slippages. The staff considers this new ESAF Arrangement to be strong and credible. However, there are a number of risks in the period ahead, like weak administrative capacity and tight fiscal conditions. I urge the authorities to be fully aware of these risks, to maintain adjustment momentum and to take corrective measures as best as they can, if slippages occur. I encourage the staff to cautiously monitor macroeconomic developments, particularly on the fiscal side, as frequently as possible.

I emphasize the importance of early regularization of both domestic and external arrears. As the staff noted, domestic arrears impede increasing national savings and investment, and external arrears have disrupted a resumption of external aid disbursements. In order to achieve sustained growth over the medium term, it is critical to enhance national savings, attract foreign investment, and establish an environment conducive to private sector-led activity. I wish the authorities every success in meeting their future challenges.

Mr. Goffinet made the following statement:

The strong political will of the Central African Republic's authorities to complete their economic reforms deserves our support. Their commitment to put the economy on a sustainable growth path is evidenced by the strength of their program. Support from the Fund will inspire support from the rest of the international community.

The authorities have taken, and continue to take, important steps that are resulting in a return to positive economic growth, which is encouraging. They should now concentrate on strengthening their fiscal performance by improving the tax system and making room for adequate social outlays and essential infrastructure investments. The authorities must also address structural problems without delay, namely creating a sound private sector

environment, restructuring the banking sector, strengthening administrative capacity and improving the statistical system. These measures will require technical assistance in various areas.

Ms. Pinzani made the following statement:

We welcome the formal adjustment program for the Central African Republic, which the authorities have been intent on for the last four years. Now it is an encouraging reality. Indeed, strict implementation of the program may provide the opportunity for a lasting solution to the damage caused by social conflict. We welcome the recent decision of the United Nations Security Council to extend the mandate of the UN mission, because it will certainly facilitate the delicate task of organizing next September's legislative election.

Turning to the program, we stress again that social peace and political stability are necessary in order to achieve a smooth, transparent, and decisive implementation of each measure envisaged in the program. The mobilization of domestic resources and the restoration of fiscal discipline are important for an improvement in social conditions, so we urge the authorities to build upon previous actions by concentrating on the renegotiation of special tax and customs agreements and adopting recommendations related to cotton sector taxation and diamond production. Such measures should strengthen and sustain revenue, and are essential for settling domestic arrears.

An early solution to the domestic arrears problem is essential for two reasons. It can contribute to relieving social tensions, guaranteeing the orderly implementation of the program. It can also foster critical support for civil servants, particularly teachers and hospital workers, and for long-awaited civil service reform. Given the lack of resources, we understand the authorities' intention to eliminate domestic arrears only in the medium term. However, we advise the authorities to publicize their plan to clear as much of the stock of arrears as possible, as soon as possible. Transparency may help to create necessary participation in a process which is bound to be extremely delicate.

Privatization may have serious social consequences if it is not accurately managed. In view of the recently deteriorated environment resulting from the mutinies, we invite the authorities to elaborate on their privatization plan and to take advantage of every offer of technical assistance. A carefully balanced program of privatization is instrumental to foster economic growth and development and social consensus. Accuracy and transparency are even more important given the need to liquidate four commercial banks and to restructure and privatize the two largest publicly owned banks. While we agree with the staff that the authorities must stand ready to take additional measures because of changing circumstances, we are concerned about the absence of any reference to specific contingency measures. We are aware of the numerous challenges facing the Central African Republic authorities. However, given the past experience, we urge them not to neglect such measures.

We welcome the new program and support the proposed decision, but, bearing in mind the country's poor track record in the past, and the recent

disruption caused by social instability, we hope that the authorities will devote extra attention to the social consequences of the adjustment process. We stand ready to revise the program should the need arise. The recent positive forecast released by the regional central bank on gross domestic product growth in the six countries that comprise the franc zone will certainly add strength to the authorities' efforts.

Mr. O'Brien made the following statement:

First of all, we wish to register our approval of the Central African Republic's request for arrangements under the Enhanced Structural Adjustment Facility. While we note that in the past there have been serious slippages in the implementation of Fund programs, it is our sincere hope that their experiences will serve as a strong incentive for a more sustained and determined implementation of the present program. Further, since the Central African Republic is unlikely to qualify for HIPC assistance, success in the ESAF-supported program is even more significant. In this regard, we are greatly encouraged by the actions of the government, following the peace accord early last year, including completion of the prior actions.

We agree with the staff that it is a strong, ambitious program and the risks involved are not to be under-estimated. We note with some concern, the poor revenue performance recorded last year. While this is perhaps not unexpected under the prevailing circumstances, it does seem to highlight an area of major weakness that must be vigorously addressed, if the program is to be successful.

Since we agree with the thrust of the program, we wish only to emphasize two further points. Firstly, it is clear that there are serious administrative and institutional weaknesses in the Central African Republic. The success of the program would, therefore, depend critically, not only on the resolve of the authorities, but the level and timeliness of technical assistance from the Fund and other multilateral and regional sources. Consequently, there should be some degree of coordination to make such assistance as effective as possible.

Secondly, given recent and prevailing circumstances, we cannot over-emphasize the value and importance of good governance. Transparency and equity in policy formulation and implementation may be one of the best safeguards against the socio-political risks, which appear to be considerable.

Finally, the early agreement of the donor community is very welcome, and provides some assurance that complementary resources will be available to the Central African Republic. We take this opportunity to wish the authorities all success in the very difficult challenges which they face.

The staff representative from the African Department noted that the Central African Republic was a member of the franc zone, which functioned much like a currency board. However, the money demand function was hard to calculate. The large fluctuation in the money demand in 1994 reflected the CFA franc devaluation. In the staff's view, estimates of

money demand in 1994 reflected the CFA franc devaluation. In the staff's view, estimates of money demand were not particularly useful in the design of programs like that for the Central African Republic.

Mr. Barro Chambrier thanked the Directors for their comments on the Central African Republic authorities' efforts to strengthen their macroeconomic policies and structural reform in the framework of the ESAF-supported program. He would convey Directors' comments and recommendations in full to the authorities, particularly taking note of the main points on the need to raise national saving and accelerate structural reform. Directors had made important points on governance issues, and on the need to maintain social consensus, which would be critical for a strong implementation of the needed reform. To achieve the authorities' objective, there would be no alternative but to fully implement the staff's recommendations.

Revenue performance in the Central African Republic was going to be critical, and the program rightly put the emphasis on that critical aspect, Mr. Barro Chambrier noted. In the context of the 1998 budget and its supplement, the authorities were strengthening their revenue collection efforts, but it needed to be borne in mind that the revenue-to-GDP ratio could increase substantially only over time. The authorities were implementing already the major measures recommended by the preceding mission from the Fund's Fiscal Affairs Department, which would be critical for the success of the program.

With respect to poverty alleviation, the authorities were concerned about the deterioration of the living standards in the Central African Republic, compounded by the loss of some 3,000 jobs during the 1996 and 1997 mutinies, Mr. Barro Chambrier pointed out. The authorities hoped the deepening of the structural reforms and the implementation of projects in social sectors of education and health would enable them to create employment and alleviate poverty.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the authorities' resolve to improve economic and financial management, which they viewed as a key element of the concerted efforts to restore peace and stability following the severe political and social unrest in 1996-97. Directors also noted the encouraging resumption of economic growth and the good domestic price performance in 1997. However, they cautioned that the economic situation remained very fragile, and called for a strong determination to improve budgetary revenues and make decisive progress in the area of structural reforms so as to alleviate poverty and consolidate the fragile social peace. They also stressed the importance of achieving a national reconciliation that would facilitate the implementation of financial and economic policies to further these objectives.

While government revenue had recovered from the severely depressed level recorded in 1996, Directors felt that this level remained insufficient to cover core government expenditure, thus giving rise to a sizable buildup of domestic and external payments arrears. Directors welcomed the initiatives taken in the context of the 1998 revised budget, but stressed that much remains to be done. They urged the authorities to step up their efforts to eliminate

exemptions, broaden the tax base, and strengthen tax and customs administration. An overhaul of the tax system should be a key reform priority for the next two years. Directors encouraged the authorities to continue to adhere strictly to their tight current expenditure stance, as well as rigorous spending procedures at all government levels. They also stressed the need to improve the quality and composition of expenditure, in particular to ensure adequate allocations for priority social sectors, and to improve the transparency of all government operations and budgetary management. Directors noted that steps taken to date in this area need to be sustained.

As regards structural reforms, Directors commended the authorities for their broad-based, yet focused and properly sequenced, approach to the privatization or restructuring of public enterprises and financial institutions. The steps already taken—to offer for sale government equity in the petroleum distribution and telecommunications sectors, initiate the farming out of the electricity company, and liquidate, privatize, or restructure state-owned banks—demonstrated the authorities' determination to improve the allocation of resources and promote private sector development. Directors noted, in particular, the importance of stepping up efforts at reestablishing a sound domestic banking system. They stressed that strict adherence to the agreed timetable and timely completion of the planned divestitures would be critical to the success of the authorities' economic program, both in 1998 and over the medium term.

Directors observed that the Central African Republic's financing requirements were large, especially under the 1998 program, mainly reflecting the need to regularize external debt payments arrears. Clearly, the balance of payments and budget positions would remain difficult over the medium term in view of the country's limited export base, weak economic structures, and continued heavy debt-service obligations. Directors emphasized the importance of sustained implementation of strong macroeconomic policies and structural reforms to improve the prospects for timely and adequate mobilization of the required amounts of donor support and debt relief on highly concessional terms. In this regard, the regularization of the arrears was seen as another essential ingredient to permit the resumption of aid flows.

Directors noted that further strengthening of institutional and administrative capacity and improvement of the quality and timeliness of economic and financial statistics remained important priorities. They considered that the provision of adequate and timely technical assistance from the Fund and other donors would be essential.

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

The Executive Board took the following decision:

1. The government of the Central African Republic has requested a three-year arrangement under the Enhanced Structural Adjustment Facility, and the first annual arrangement thereunder.

2. The Fund notes the policy framework paper for the Central African Republic set forth in EBD/98/50.

3. The Fund approves the arrangements set forth in EBS/98/117, Supplement 1.

Decision No. 11764-(98/79), adopted
July 20, 1998

**3. RUSSIAN FEDERATION—EXTENDED ARRANGEMENT—
AUGMENTATION; AND PURCHASE TRANSACTION—
COMPENSATORY AND CONTINGENCY FINANCING FACILITY**

The Executive Directors considered a staff paper on requests by the Russian Federation for an augmentation of the Extended Arrangement and for a purchase in an amount equivalent to SDR 2,156.55 million under the Compensatory and Contingency Financing Facility (CCFF) (EBS/98/120, Sup. 1, 7/17/98; Sup. 2, 7/20/98; and Sup. 3, 7/20/98). They also had before them the authorities' letter of intent (EBS/98/120, 7/16/98; and Sup. 4, 7/22/98).

Mr. Mozhin made the following statement:

Since late October 1997, Russia has been experiencing severe financial market pressures. In the last couple of weeks, these pressures have intensified dramatically, and it has become clear that only large-scale external financial assistance, together with a comprehensive adjustment and reform program, will allow Russia to avoid a full-blown exchange-rate crisis.

To some extent, Russia has become a victim of bad luck. At the very moment when financial stability was largely achieved, and when long-awaited economic growth was about to begin, unfavorable developments outside Russia—the financial market turmoil in Asia followed by the sharp fall in international oil prices—coupled with some political and social tensions at home, conspired to bring Russia again to the brink of disaster. At the same time, the authorities fully recognize that Russia's own weaknesses, and especially the unsatisfactory state of public finances, have greatly contributed to the loss of financial market confidence.

The legitimate question is: Why, in the seventh year of the transition, is Russia's fiscal deficit still so large? Of course, there are several answers to this question, some of them fairly obvious. First, due to serious policy disagreements within the government, its own efforts to reduce the fiscal deficit—especially in the area of revenue collection—have not been strong enough. Second, fiscal policy in Russia is a domain of joint responsibility of the executive and the legislative branches of power, and conflicts between the Russian government and the Russian Parliament have played a highly negative role. At the same time, I firmly believe that one of the main reasons for the large fiscal deficit in Russia is the state of the real sector of the Russian economy.

Today, with the benefit of hindsight, many observers are of the view that the degree to which the USSR economy was distorted has been largely underestimated. On top of regular distortions common to any non-market economy, Russia inherited special distortions in two areas—a huge military sector and distortions associated with the spacial location of Russian industry. I have to admit that, so far, many (if not most) Russian enterprises outside the resource sector have failed to adjust to the conditions of a market economy. A typical Russian manufacturing enterprise is practically bankrupt, and is able to survive only by subsidizing itself through nonpayments—nonpayments to suppliers, nonpayments of wages, nonpayments of taxes, etc. In fact, many of these enterprises are value subtracting. They eagerly engage in barter and other non-transparent schemes with a strong element of fraud.

The legitimate question is: Why this whole situation was not decisively addressed earlier? The remedy is, of course, well-known—one has to cut electricity and gas supply, to initiate bankruptcy procedures, etc. However, in *an economy like this, it is practically impossible to distinguish viable enterprises from the non-viable*. In every individual case it is very difficult to figure out whether a particular enterprise is a gross violator or a victim of the misbehavior of others. At the same time, it was widely believed that before taking strong steps we had to wait for economic growth to begin, that many enterprises were fundamentally viable but suffering from the recessionary environment, and that they just needed some more time to adjust. Why were there mass bankruptcies when many successful transition economies have avoided them? Policy disagreements within the cabinet, resistance by the regional authorities, and social considerations also played a role.

Every crisis creates both risks and chances. The main result of the current financial crisis in Russia is that now there is no need to persuade anybody in the Russian Government that strong steps can not be postponed any longer. The program that is submitted today for your consideration is quite radical in all its elements—the size of the fiscal adjustment, the scale of structural reform measures, etc. I will not attempt to comment on individual measures, as they are described in both the statement of the Russian Government and the Central Bank of Russia, and the staff report. Let me only say that the contribution of the Fund staff has been great, and that the Russian authorities are extremely grateful for their exceptionally hard work in Moscow and in Washington over the past three weeks.

The final legitimate question is: what are the reasons for believing that this time around the program will be fully implemented? Here are some of them.

First, there is simply no alternative. We want to get out of this financial crisis and never experience it again. And we are well aware that no amount of external financial assistance will help unless we fix the budget once and for all and fully implement the whole program.

Second, the current cabinet is the first Russian government since the very start of the transition process that is entirely coherent and fully united

behind the program. Moreover, the authorities have already demonstrated changes in their attitude, as evidenced by their tough actions against Gazprom, major oil companies, and other tax delinquents.

Third, this time around, the authorities intend to be absolutely honest and transparent vis-a-vis the society at large. It has been decided that the full text of the Statement signed by the Prime Minister and the central bank Governor will be made public.

I know that you will have to make a difficult decision. Indeed, the Russian authorities have requested very large additional access to Fund resources which are scarce. I know that there are reasons to view this operation as a very risky one. However, isn't the alternative even more risky? On behalf of my authorities, I am asking you to support the program.

The Director of the European II Department noted that nearly all of Russia's prior actions had been completed. Two areas that had not yet been completed were the personal income tax and the pension fund finances. In the case of the personal income tax, the Duma had not finished considering the recommendations of the government, and had agreed to reconvene in the middle of August to address that issue. In the case of the pension fund finances, a number of measures needed to be taken to put the pension fund finances in 1998 and beyond onto a firmer basis. The authorities found that some of the measures were more difficult to implement than originally considered. The final resolution of pension fund finances would need to be taken up during the Duma session in August.

Mr. Sivaraman made the following statement:

I would like to compliment the staff and the Russian authorities for the successful conclusion of the negotiations. I congratulate the authorities for having taken a number of steps to complete the prior action program. However, it is disheartening to note that Russia, which made substantial progress toward establishing a stable market economy and was showing signs of positive rates of growth, has taken a sudden backslide.

The staff appraisal at the time of the previous review focused mainly on the problems in fiscal management. It is now evident that the Russian problems are deeper than that. While the immediate steps that the government has already taken, and those that are proposed to be taken in the near future, would instill some confidence in markets, there is a need to further study the issues that caused the fluctuations in the Russian economy.

Macroeconomic prescriptions and the determination of a government to implement them will not yield the desired results if the institutional and legal framework is inadequate. The authorities should consider constituting expert groups drawn from within and outside Russia to thoroughly reexamine the institutional and legal framework.

While the staff has pointed out the fragility of the banking system, they have not indicated the size of the problems and the steps needed to tackle them. It would be useful for the Russian authorities to produce a detailed

portfolio analysis of the banking system so that they are adequately prepared to meet any problems in this area.

The staff has pointed to Russia's dependence on short-term capital flows, but the size of the short-term debt has not been properly addressed. The problem of tax arrears and arrear payments by the government seems to have entrenched itself in the economy. Unless it is tackled effectively, it could be a drag on the future progress of Russia. The velocity of circulation in Russia is high. The reasons for this and its implications for policies are not clear. Could the staff perhaps comment on that issue.

The federal-local fiscal arrangement in Russia is still quite complex, in spite of the enactment of the law on that subject. While this may not be the opportune time to streamline the whole system of taxation powers, tax sharing, and expenditure responsibilities, it would be appropriate for the Russian authorities to appoint a fiscal commission to look into the various government fiscal arrangements.

I support the request for augmentation of the Extended Arrangement and the request for repurchase under the Compensatory and Contingency Financing Facility (CCFF).

Mr. Kiekens made the following statement:

With the proposed financial support, the Fund is coming to the end of its ability to provide financial assistance to Russia. Russia's external debt is growing very rapidly. The public external debt service is increasing from \$9 billion last year to an estimated \$20 billion next year. By converting large parts of its domestic debt into foreign currency debt, the Russian authorities are making a large bet on the success of their program. Any new crisis after today's financial support will be even more devastating than the present market turmoil. All branches of the Russian government must work to implement the program flawlessly. If not, the IMF money will be wasted, and today's financial package will only postpone what it seeks to avert.

I read the staff report with mixed feelings. Depending on further specifications in the weeks and months to come, it may be strong enough to address Russian main problems if—and this is a big if—it can be implemented fully. For this, to quote from Prime Minister Kiriyenko's letter of intent, "Broad political support ... including from the Duma and the Federation Council is necessary because such support is critical for the strategy's success." The Duma's refusal to approve all elements of the government's anti-crisis program does not augur well. And while I welcome the president's readiness to implement the missing measures by decree, I recall Mr. Odling-Smee's remark during last week's video conference that Russian ownership of the program is not as strong as he had hoped.

The Russian authorities intend to publish the letter of intent and the Memorandum on Economic and Stabilization Policies. I welcome this transparency, needed to allow market participants to make an informed

assessment of the strength of the program, rather than naively believing that the size of the Fund's financial support automatically guarantees a strong program. Russia's present crisis proves that market participants were too confident in Russia's policies, inter alia because the Fund gave wrong signals to the markets. Welcome as this increased transparency is, there is reason for major concern that it was considered too risky to mention during the Duma's recent meeting the president's outline for the 1999 budget, which contains details of many of the measures agreed with the Fund.

Notwithstanding, Mr. Mozhin assures the Board that the crisis has now reached a stage where everyone in the Russian Government realizes that strong steps can no longer be postponed. But the Duma's discussion of the Government anti-crisis package reveals that there is still strong opposition to many measures, and that program implementation is encountering serious resistance. And although the staff assures the Board that the President can impose the necessary measures by decree, we must hope that these decrees will not be challenged. In any case, it seems doubtful that the extensive anti-crisis program can be successfully completed in the face of parliamentary opposition and parliamentary elections next year. I think that the Duma's rejection of key fiscal measures should not be disregarded in making today's decision. I will revert to this issue later.

Russia's fiscal program is presented as a strong one. Indeed, reducing the federal budget deficit from 7 percent of GDP last year to 2.8 percent next year is, at first glance, reassuring. The authorities stress that the main burden of the fiscal adjustment has now shifted from spending cuts to revenue measures. I would like to observe that assuming that all measures are fully implemented, tax revenues in 1999 will exceed last year's tax receipts by only 1.1 percent of GDP. But next year, interest charges are expected to be 1.1 percent of GDP greater than interest paid in 1997, which will still be 43 percent of tax revenues. For these reasons the 4.3 percent improvement in the federal government's borrowing requirement between 1997 and 1999 comes entirely from reductions in primary expenditures, for which the staff report does not provide a breakdown by function. In addition, I observe that from the 80 billion rubles in additional revenues targeted for 1999, the revenues from putting the VAT on an accrual basis, and from the temporary import surcharge, will last for only one year. Furthermore, the transfer to the federal budget of 20 percent of personal income tax receipts does not add any revenue to the general government budget. Hence, even assuming that the revenue package is fully effective, over 40 percent of it does not represent a structural improvement in Russia's public finances.

Without further fiscal measures, I doubt that the fiscal adjustment will be sustainable. First, the pension fund has accumulated significant arrears that must be cleared up. The failure to meet the prior action of reducing the average wage as a basis for calculating pension rights, is worrisome. Second, regional authorities are certain to put up a strong resistance to the federal authorities' effort to exert stronger control over regional finances. And third, and most important, the problems of the banking sector threaten to become a large liability for the public sector. I urge the authorities to speed up the design and

implementation of a strategy for bank restructuring in order to shorten the period during which the central bank must continue to provide liquidity to the banking system. Despite the many safeguards and limitations, the central bank's provision of liquidity support for bank mergers could be risky.

The staff rightly observes that a very urgent task is to restore market confidence in the sustainability of the government's fiscal position, in order to avoid a currency devaluation. In this connection, it is worrisome that after the announcement of the program, Russia's risk premium of 940 basis points is still 200 basis points higher than at the time of its last Eurobond issue three weeks ago. Avoiding devaluation, however, will require more than dealing with the acute financial problems connected with the crisis, because the causes of the crisis are not exclusively financial.

Mr. Mozhin points out the dismal situation of the enterprise sector. I agree that the enterprises' weak financial situation, their lack of hard budget constraints, and their habit of financing their operations by accumulating arrears, all have increased Russia's vulnerability to external shocks. He is also correct that if the habit of accumulating arrears and refusing to honor obligations infects the whole economy, it becomes difficult to distinguish between violators and victims. At the present stage, I fear there may be no clear way to clean up the problem without harming the victims. Waiting for growth to start before moving strongly against the violators only perpetuates the vicious circle.

Russia can strengthen its financial position and become less vulnerable to shifts in market sentiment by attracting more foreign direct investment. I therefore applaud the authorities' ambitious privatization program and the steps taken to protect the interests of small shareholders. Such measures are long overdue. Russia has come to be known as a country where minority shareholders, both domestic and foreign, see their interests trampled by unrestrained, unlawful practices of large shareholders. Unless these abuses end, investors will not want to do business in Russia.

At our last review, several Directors protested the failure to perform a promised prior action by initiating proceedings against the 20 largest tax debtors. I was therefore amazed that paragraph 24 reports that actions have been taken against only four oil companies. Could the staff explain what further actions have been taken since the last Board meeting against other large delinquent taxpayers?

Russian is asking the Fund to provide a very large financial support. I regret that the staff report gives little or no justification for the amounts being requested under the EFF and SRF. In addition, I am concerned that the front-loading of our financial support is undermining the Fund's leverage to obtain program implementation.

Many of the structural reforms contained in the program are long overdue. Indeed, I was surprised to learn that some of them had not yet been implemented, since Russian has been pursuing Fund programs for more than

four years. The program calls for the recovery this year of 50 percent of the cost of household utility services, such as electricity and gas, and an additional 15 percent each year from now on. I recall that full recovery of utility costs in the short run was a condition of Belarus's 1995 Stand-By Arrangement, as also for other CIS countries. We all know that such measures are politically difficult. Nonetheless, I wonder why Russia's program does not aim to achieve full cost recovery at least as fast as other transition countries.

Russia's Article IV consultation will soon be overdue. I therefore insist that Russia's Article IV consultation be discussed in the Board this fall. This consultation should focus, *inter alia*, on the risks for the program's implementation, further examine how Russia can create a business-friendly environment and reduce capital outflows, which are a structurally caused and long-standing weakness of the economy that today's staff paper does not even mention. The report is an opportunity to complement the partial information given in staff reports that focus narrowly on the review of Russia's program. One of the most important elements missing from these reports are data on Russia's banking sector, and a functional breakdown of budgetary spending.

The behavior of the Sberbank on the GKO market, and its relations with the central bank, have been investigated by the staff. I regret that the results of this inquiry were not mentioned in the staff report, and I would like to invite the staff to give us an oral report now.

I welcome the planned administrative restructuring of Gazprom into four operational units with independent management teams. Can the staff assure us that this will make it easier for other gas producers to gain access to Gazprom's pipeline system at market rates and promote greater competition in Russia's energy market?

At the outset of my intervention, I mentioned that the Duma's rejection of important elements of the proposed fiscal package should not remain without consequences for today's decision. Although the president has partly remedied the Duma's refusal by imposing the proposed measures by decree, those decrees will only become effective after ten days, provided they are not overturned by the Duma. I therefore suggest postponing the release of the first tranches under the EFF and SRF until the presidential decrees come into effect.

Mr. Kafka made the following statement:

We have before us a set of requests by the Russian Federation.

The authorities have formulated an economic policy consisting of a set of actions additional to those envisaged under the 1998 program, supported by the existing extended arrangement. The new policy package has three principal aspects: a strengthened structural agenda for 1998; a major fiscal system adjustment for 1999 with a substantial number of the fiscal measures to be implemented in 1998; and an attack on the government's short-term debt position, through a lengthening of the maturity profile.

In recognition of the difficulties Russia will face in addressing short-term capital requirements in the near future, the Russian program is being supported by substantial amounts of longer-term finance.

The policy of the authorities aims at fiscal adjustment mostly through a significant revenue improvement which should bring the primary balance from approximate equilibrium in 1998 to a surplus of around 3 percent of GDP in 1999. This assumes that the substantial expenditure cuts agreed under the 1998 EFF program are implemented.

The increases in revenue will come from improved tax administration and tax policy as described in paragraph 23 of the staff paper. An important part of the programme will be the attachment of effective conditionality to the resources received by the Federal territories from the Federal government. Another important part of the program is represented by the conversion of treasury bills into longer-term Euro bonds. In the event that interest costs exceed expectation the Russian government is committed to take additional revenue measures.

An important measure underpinning revenue projections will be the denial of access to the government oil pipeline to large oil holding companies.

Also important are a series of structural reforms which will have to be undertaken particularly designed to meet the problems of non-payment and barter, particularly in the infrastructural monopoly sector. The authorities also see the labor market reforms as a key element in the restructuring of the economy.

The authorities are also committed to a comprehensive approach to address the under-lying weaknesses in the banking system. The Central Bank of Russia will continue to provide liquidity assistance to facilitate takeover of problem banks by healthy banks. This presents delicate problems because a desirable procedure would be that the resources should be provided through budgetary resources and not by the central bank. The authorities indicated that this might create considerable problems.

We hope the Russian authorities will be able to take soon most of the prior actions still required.

It is obvious that the revised Russian program comprises extremely serious risks for the Fund. Without denying that the alternative is also dangerous, we must, therefore, one more time, face up to these risks. But we must absolutely avoid any continuation or their repetition.

Mr. Esdar made the following statement:

Today we are faced with a very difficult or, as Mr. Kafka has put it, delicate, decision. We do it with the expectation that at this crossroad, Russia will head in the right direction and that a new, more positive chapter in the reform- and transformation process in Russia will start today.

Whereas the tough monetary policy followed by the Russian central bank has resulted in remarkable progress in bringing down inflation and stabilizing the exchange rate, while many important structural reforms have been brought ahead, progress in the fiscal area has been clearly insufficient—witness the repeatedly failed attempts to get the fiscal situation under control.

We have discussed the reasons for those program deviations in the past quite frequently. The main problems have resulted from weak administrative capacities and weak tax codes that led to a culture of non-payment. Efforts at tax collection were clearly insufficient and the tax system provided the wrong incentives because it was cumbersome and too difficult to be implemented efficiently. Policy disagreements within the government and conflicts between the government and the parliament have caused serious delays, as described by Mr. Mozhin. However, there are also significant external effects which contributed to problems like the contagion effects from Asia and the steep fall of global oil prices. Changes in government and shifts in responsibilities have added to uncertainties and slowed down the reform process also in the structural area.

The program presented to us today tries to deal with the shortcomings of the past by a “three-pronged approach.” First, there is the attempt to address the fiscal problem at its roots. We very much welcome that the structural reasons for the failure to meet revenue targets, i.e., inadequate revenue collection, insufficient instruments to deal with tax arrears or enterprises which refused tax payments, are addressed in a systemic way in chapter 1 of the tax code.

We also endorse the changes in tax policy, particularly the unification of the VAT rates which has been achieved at least partially, the removal of tax exemptions and the strengthening of the central government in the revenue system. I also strongly welcome the envisaged strengthening of instruments of the central government to penalize or ban the use of offsets, acceptance of arrears and inefficient budgetary procedures at the local and regional levels.

On the expenditure side, it is a big progress that for the 1999 budget spending limits will be based on the detailed plans of final budget recipients instead of simply transferring resources to the spending ministries. However, progress in expenditure control is far from complete and more has to be done to integrate all federal budget agencies—especially the Ministry of Defense—into the federal treasury system.

Secondly, there was the attempt to present the program with its structural elements to the Board only after crucial elements of the package have been passed by the Duma. This reflected the fact that former programs were not implemented comprehensively because the implied legislation did not materialize. In this regard, the recent outcome so far is certainly disappointing. We have been informed today that substantial elements of the fiscal program have been rejected by the Duma last Friday. The attempt to offset these shortcomings by presidential decrees might help to bridge the time until a

broader consensus can be achieved. However, this decree procedure raises substantial uncertainties, questions and doubts.

However, even if the "decree approach"—as a second-best solution—will work this time, the objective has to remain to make all efforts to generate the necessary broad-based consensus for reform. We have learned the lessons repeatedly and quite recently in Asia, that the chances to implement a program and to undertake the necessary reforms to restructure and liberalize the economy, depend on the degree of participation and acceptance by the population. An efficient and well-targeted social security system, complete abolishment of wage and pension arrears, predictability and transparency of the public sector and a well-targeted incentive and property right framework are crucial elements in this regard. We would encourage the authorities to intensify the dialogue and to strengthen this reform process in such a way. Here we welcome the announcement of Mr. Mozhin that the full text of the statement signed by the prime minister and the central bank Governor will be made public. This greater transparency should help to intensify the reform dialogue.

The third element which generates some hope is the fact that the new government stands fully behind the reform program in all its components. The admirable efforts of the president and the government to raise the necessary support in the Duma confirm this commitment. This is also underlined by the government's firm intentions to deal in a consequent manner with tax arrears of influential enterprises and to address the problems of nonpayments and of infrastructure monopolies.

Against this background, we strongly hope that the envisaged substantial reduction of the fiscal deficit can be achieved. An improvement of about three percentage points within the next 12 months certainly is not only ambitious but also very necessary to turn the economy around. The underlying revenue target of 13 percent of GDP in 1999 is certainly more appropriate but should be clearly seen as a lower limit. If slippages in the fiscal area should occur, corrective actions have to be found on the revenue side. In this context, I welcome the intention of the authorities to take compensating revenue measures if the projected interest costs exceed the target. A further reduction of expenditures seems to be hardly justifiable given that payments for social needs are already at the minimum level. Additional cuts would risk to further erode the social consensus.

We can endorse the policy framework suggested under the program; we can also side with the detailed policy recommendations. I would like to highlight just two structural points, namely the importance to accelerate and go ahead with a transparent privatization process and to speed up the restructuring of the vulnerable banking sector. Weak and insolvent banks should be closed or restructured and the accounting legal and regulatory framework should be improved based on strengthened banking supervision.

We also welcome that the conversion of the GKO's in foreign currency euro bonds with longer maturities seems to have been successful. We have learned today that GKO's in the magnitude of around 6 billion \$ have been

converted, with a spread of 940 basis points. I share the concerns of Mr. Kiekens that the outcome of this conversion puts considerable pressure on the budget for a very long time, given that some of the conversion bonds have maturities of twenty years. I wonder whether such an outcome could be regarded as fair and balanced. However, and with this caveat, there can be no lasting solutions without active and broad participation by the private creditors.

To conclude, I would like to stress that this program agreement for Russia offers great opportunities but, on the other hand, we all, and in particular the Russian authorities, have to be aware that there is no further room for slippages. We, therefore, support the request to rephrase the additional resources from the Fund to allow the access to be more closely aligned with the implementation of the fiscal measures needed to close the budget gap, as described in EBS/98/120, Supplement 2. Markets have reacted positively to the announcement of this program. A renewed disappointment would risk to again erode the confidence in the capability of the authorities to overcome the problems. We are very close to the end of the road.

But this is also true with regard to the ability of this institution to help. The need to tap the reserve tank of the GAB in order to provide this huge financial support demonstrates the seriousness of the situation. At the same time, the credibility of the Fund's policy advice and judgement is at stake. Thus, it is in all our interest, but most of all in the interest of the Russian people and economy, that the Russian authorities succeed in their endeavors through a forceful and comprehensive implementation of the program. Building on this, we support this program also by contributing our share to the GAB-activation. However, in this overall context, we are certainly not paying lip service, when we wish the authorities much success.

Mr. Askari-Rankouhi made the following statement:

The fundamental reason for the uneven implementation of Fund-supported programs in the past, as Mr. Kiekens also noted, has been the failure of the government to forge a broad political consensus on the need for tough and painful adjustment measures. This, I believe, continues to be the case as reflected in the strategy used to complete the prior actions. Clearly, the Duma is not supporting many of the actions taken, which is reflected in its refusal to pass a couple of key fiscal measures. The use of Presidential decrees and other tactics to bypass the Duma may work in the short run, but are not sustainable in the longer run. Mr. Mozhin states that the Russian cabinet is now unified in its support for the program. This is a positive sign, but is not enough. The legislative branch of the government will have to be convinced of the need to tackle the fundamental problems of the Russian economy. I think the Fund can play a productive role in this area. I urge the staff and management to initiate direct contacts with key parliamentary figures to explain the program with a view to help broaden the political support for it. The Fund must be more proactive in this area as it has taken considerable risks both financially and in terms of its credibility.

The principle elements of an appropriate adjustment program for Russia are well known and have not changed since the transition began. Russia needs to put its fiscal house in order, direct monetary policy towards achieving price stability, promote the development of the private sector, restructure its industries and the banking system, and address governance issues in both public and corporate sectors. As others have said, the problem in Russia has been the implementation of the program and not the program itself. Improving implementation should be the focus of the authorities' efforts this time.

The Russian authorities must put in place, as a matter of urgent priority, a functional and effective tax system. The steps that have been taken recently to raise tax revenues are mostly temporary measures that may result in a partial clearance of some tax arrears, but will not create a reliable tax system. Given the critical importance of reforming the tax system, I am troubled by the fact that only the approval of Part I of the Tax Code was required under the program. Further, according to paragraph 15 of the LOI, there are key deficiencies in Part I which will not be corrected until January 1, 1999, and Part II of the Tax Code will be considered only some time next year. So, the additional financial support of \$11.2 billion will be fully disbursed even if the authorities fail to modify Part I.

I believe the passage of the full Tax Code, or at least the modification of the deficiencies in Part I, should have been a performance criteria for the next review. As I understand it, the version of Part I that has been approved will not help raise revenues in any meaningful way. Could the staff explain why the disbursement of the September tranche was not made conditional on progress in this area?

Further on the fiscal side, I share Mr. Kiekens's concern that the mix of fiscal adjustments continues to be weighted towards expenditures. From 1997 to 1999, revenues are expected to increase by 1.1 percent of GDP whereas non-interest expenditures are projected to fall by 4.3 percent of GDP (Table 6). As this chair has stated repeatedly in the past, continued compression of spending is not a sustainable way to tackle the fiscal imbalance in Russia. I recognize the need to address shortcomings in expenditure management and control, and welcome the authorities' efforts in this regard. To the extent that the planned reductions in expenditures arise from increased cost efficiency and lower non-productive spending, they will help the restructuring of the economy. Otherwise, the spending cuts could threaten social and economic stability of Russia. It would be useful to have a break down of spending cuts.

I welcome the program's emphasis on structural reforms targeted on changing the culture of nonpayment. This is a fundamental problem in Russia and has to be dealt with forcefully. In general, Russia has made good progress on the structural front, but chronic fiscal problems have recently diverted attention from structural issues, which are key to sustained economic recovery.

My main concern on the structural front is the banking system. The staff report points to increased exposure of the banking system to foreign currency and counter-party risk arising from possible defaults in off-balance

sheet contracts, inadequate prudential requirements for coverage of foreign currency positions, and substantial foreign-currency denominated lending. To restore confidence in the financial system, the regulation of banks' lending practices must be improved. I also share the staff's concern about the role of the central bank in dealing with problem banks. Have the authorities considered establishing a separate agency, like IBRA in Indonesia, to carry out this task?

Poor governance has significantly contributed to the failure of the Russian authorities to transform the economy. Unfortunately, neither the staff report nor the LOI provide assurances that there is a well-defined plan to improve governance.

On the exchange rate policy, I realize that the staff and many of colleagues here believe that maintaining a relatively fixed exchange rate for the ruble is a key to restoring confidence. I could agree that in the midst of a liquidity crisis, allowing the exchange rate to depreciate sharply may not be appropriate. However, I am not certain that we are dealing with a short-term liquidity problem. Russia has experienced a large negative terms of trade shock. Over the past 12 months, oil prices have fallen by 29 percent, nickel prices by 33 percent, copper prices by 31 percent and aluminum prices by 16 percent. This is clearly a deterioration in the fundamentals and requires some exchange rate adjustments. The question that I want to raise is that given the large external financial support that will be provided to Russia in the current package, should Russia allow some exchange rate adjustments within the 15 percent band, which by the way has not been used since its announcement earlier this year.

In conclusion, I agree with Mr. Mozhin that the alternative to providing increased financial support could be riskier. However, my authorities support for the proposed decision has been conditional on the completion of the prior actions. In light of the failure of the Duma to pass two key fiscal measures, and the doubts expressed in the staff's Supplement about the passage of those measures in August when the Duma meets again, I would like to hear the staff's and the Directors' views about Mr. Kiekens' proposal for a 10-day delay in the disbursement of the EFF portion of the package before deciding whether to support the proposed decision.

Mr. Yoshimura made the following statement:

Even after we completed the program review last month in the Board, the pressure in the financial market did not subside and it has become necessary to formulate more drastic measures to quiet Russia's economic imbalance. Against this background, the authorities have announced various anticrisis measures and have worked out with the Fund a strengthening of the program. The program that we have before us today contains some promising measures that focus on addressing the fiscal imbalance. Moreover, some of the measures on the fiscal side were to be approved by the parliament as prior actions to the Board meeting. While it is regrettable that some of these measures were not approved by parliament, I note that presidential decrees were issued to cover

most of the measures in effect. I understand that the anti crisis measures and the strengthened measures show that the determination of the authorities to improve fiscal conditions, but I have to say here that the most important thing is full implementation. It is welcomed in this aspect that the president himself has been showing very strong commitment to the implementation of the necessary measures. Therefore, with the understanding that measures in the program supported by the president's commitment will be fully implemented, I am prepared to support the proposed decision today.

The most important pillar of the program continues to be the measures on the fiscal side. The measures presented in the staff paper today are stronger than those endorsed by the Board last month, particularly on the revenue side. The effectiveness of these measures has been secured by the approval of the parliament and the presidential decrees and I would like to reiterate the importance of full implementation of the measures supported by presidential decree. Moreover, I would also emphasize that it is absolutely critical to implement the measures that have already been endorsed by the Board to enhance revenue and strengthen expenditure control toward the end of this year. The president issued a decree to instruct the Government to draft a budget for 1999 in line with the program target that envisages a remarkable improvement in the primary balance. The real issue, however, is whether the budget would be approved by parliament and executed as planned. I urge the Government to make their best effort to ensure with the leadership of the president that the 1999 budget is formulated and executed as envisaged in the program.

On monetary policy, I think it is appropriate to maintain the current stance focusing exchange rate stability, but if I may comment on the exchange rate policy against the background of heavy market pressure, I wonder whether it is appropriate to stick to current policy of setting a narrow band to contain the movement of the exchange rate on daily basis. We discussed exchange rate policy at the Board last month, and I thought the staff's view was reasonable, that a devaluation of the ruble at this stage would create considerable pressure on the banking sector and, hence, damage the whole economy. But, I would like to ask the staff once again whether, given the continued pressure on the exchange rate, even after the last Board meeting, it thinks that a more flexible exchange rate policy might not be more appropriate.

On the structural side, it is welcome that the authorities intend to make progress in structural reform, including on the critical issue of nonpayment.

On the plan to deal with problem banks, I am inclined to think that more prompt and decisive actions are needed. The authorities' plan to implement a scheme whereby the central bank will continue to extend liquidity assistance to promote the merger of systemically important banks before a comprehensive restructuring plan is developed within the next few months. I am concerned that this scheme might endanger the financial integrity of the central bank. Of course, I understand that providing fiscal support to deal with problem banks is difficult based on the current fiscal conditions. Therefore, it is

all the more important that the authorities formulate a comprehensive plan as soon as possible.

The scheme to convert the GKO to foreign currency denominated bonds will mitigate an immediate burden of rollover and repayment. However, I share the concern of Mr. Kiekens on the future burden of this scheme, and I would like to emphasize that there should be a fair burden sharing by private sectors although I understand this may be difficult in Russia's case and the issue here is management of the sovereign bonds. I would like to ask the staff whether the convergence scheme has any element to ensure fair burden sharing by private sectors.

Looking at Russia's capacity to repay the Fund, I cannot help being concerned about the heavy repayment burden, particularly in 1999 and the year 2000. Clearly, economic stability has to be established very quickly through the prompt implementation of the necessary reforms or the Fund's financial resources will be at risk. I would, therefore, reiterate that full implementation of the program is absolutely critical and there is no room for further slippage.

With these remarks, I support the proposed decision and wish the authorities success in tackling the difficult tasks ahead.

Mr. Milleron made the following statement:

At the time of the last Board meeting concerning Russia, I stated that my authorities were ready to back additional financial assistance as necessary and appropriate, contingent upon two major conditions: First, a full statement of the budgetary problem; and second, a firm move forward on the structural program. Now, the questions are, does the program contain the appropriate measures from these two points of view. It appears to be approximately the case. And as usual with Russia, the greatest challenge lies in a sustained implementation of policy actions. On that the jury is still out. Admittedly, the new government looks very coherent and committed to reform. The Central Bank has on many occasions shown skillfulness and determination, and the seriousness of the situation may help spur economic reform and crack down on the destructive behavior of rent-seeking interest groups. Yet, very partial support from the Duma to embrace the important adjustment and reform agenda, and therefore the lack of a broad ownership of the program, does not provide full comfort, especially when considering the exceptional size of financial assistance provided, and the delicate financial situation of the Fund.

With regard to fiscal policy, I welcome the adoption of tax measures under the program. But as stated before, failure of the Duma to adopt some of the key tax legislation is a real matter for concern and disappointment, especially with regard to the value-added tax proposal, which appears to be a major plank of the package. The delay in the decision relating to the personal income tax and the pension, such as recently reported, is also worrisome. In light of this, I see as warranted the proposed rephasing of additional resources between the July and September purchases. The passage of the first part of the new Tax Code is a positive development. Also, this has been expected for a

long time. I look forward to further progress by the next review with regard to the adoption of Part II of the Tax Code.

The resolution to noticeably improve the fiscal situation in 1999, mostly through an improvement of tax collection, is an important and valuable commitment. Yet, such a commitment has been made before in 1997 and 1998, and the outcome was disappointing. It is, furthermore, striking to me that the fiscal adjustment in 1999. One of the key measures of the enhanced economic policy package rests on a decree instructing the government to draft a budget law for the next year, the legal value of which does not appear to be very strong.

As repeated many times, vigorous and steady efforts by the tax administration, particularly those aimed at pursuing the largest corporate tax debtors, are clearly required. In this regard, I welcome the agreement reached between the Government and Gazprom on the mutual payment of taxes and dues. I also attach much importance to the mechanism ensuring as of July 1 that no oil company in tax arrears would have access to the oil export pipelines, and I appreciate related information provided by the staff. Do we have the assurance that the mechanism is fully applied without exception? It is naturally critical to the new recourse to monetary offset to be made.

On the question of debt restructuring, I have some doubts with regard to the authorities' scheme aimed at converting GKO into longer term dollar obligations. I naturally understand the argument for longer maturity and lower interest charges. Yet, one can remain skeptical about the extent of investors' interest in the deal. Will investors holding GKO decide to hold entirely different bonds? And now that the risk of devaluation is reduced, why should these be traded in? As a matter of fact, it is rather paradoxical to see staff backing a conversion scheme which should meet sensible demand, especially if the adjustment program's credibility is low. More importantly, one should not forget the fact that such a conversion will make the currency risk shouldered by the Government, and this should be closely monitored.

As for structural reforms, finally, I support the emphasis placed on actions to address the nonpayment problem, and the improvement of corporate governance through law enforcement and stricter and more transparent rules. Special attention to the restructuring of the banking sector should be given priority, and addressing current shortcomings seems to be an urgent task. I share the concern expressed by the staff about the liquidity assistance scheme of the Central Bank to facilitate mergers, and I look forward to a external restructuring strategy being devised with coordinated advice of the World Bank and the Fund.

I support the view that funds for possible bank rehabilitation should be provided through budgetary resources and not by the Central Bank. Finally, I welcome the emphasis placed on data transparency.

I do not want to conclude without paying tribute to the staff for the remarkable work that has been performed for so many weeks now. With these

comments, I support the proposed decision, albeit being somewhat uneasy about the associated risk for the Fund, as candidly acknowledged by the staff in its report. Mr. Mozhin rightly points to the absence of a real alternative, and moreover we should keep in mind the systemic risk of an exchange rate crisis in Russia. As usual in such a matter, we are faced with a second-best optimum. Clearly, no miracle solution exists that could transform the Russian outlook into a fully risk-exempt situation. In the final analysis, the only way to address this threat is a forceful implementation of the program, and a compromising stance by the Fund while assessing compliance under it.

Mr. Zhang made the following statement:

Let me first express our appreciation to the staff for their hard work, and for providing us a well-prepared paper within such a short time. Even though I general agree with the thrust of staff appraisal and support the proposed decision, I would like to highlight the following points for emphasis.

First, I welcome the strong determination the new Russian government attached to the program and the prior actions which are being taken by the authorities to strengthen their efforts to correct the fiscal imbalance. As the staff reported, the volatile financial markets in Russia and the continued decline of oil and gas prices in the world market undermined Russia's fiscal consolidation and economic fundamentals. The authorities have been confronted with severe fiscal and BOP difficulties. Responding to these difficulties, the authorities announced an enhanced and comprehensive package of stabilization measures to address fiscal imbalance and accelerate structural reforms, which reflected the firm determination of the new government at different levels and the Chambers of the Federal Assembly to overcome the current turmoil. I appreciate the authorities' prompt actions and think that these policy measures are not only necessary but also essential to Russia's efforts to achieve sustained economic growth and stabilization.

Second, I concur with the staff that actions of great significance that are being taken to get the enhanced policy package off the ground are urgently needed, and the government's efforts to secure political support for these policies are absolutely necessary. Mr. Mozhin had provided us with candid and concise answers in his helpful buff statement to the question of why in the seventh year of the transition, Russia's fiscal deficit is still so large. In the process of implementing these policies, the authorities will inevitably have to cope with difficult obstacles of various kinds including significant political resistance. Therefore, the authorities are encouraged to make greater and bolder efforts to firmly and vigorously implement the program.

Third, with regard to the macroeconomic policies, on the fiscal policy front, I concur with the staff that the authorities' adjustment strategy should mainly focus on the revenue side and specifically on broadening the statutory tax base as well as strengthening tax administration. In this context, I welcome the authorities' recent action in conversion of short-term Treasury bills into longer-term Eurobonds. This arrangement could cushion the budget pressure, however, the postponed repayment of the debt will ultimately rely on the

revenue performance. In addition, I would like to caution that further reduction of the fiscal expenditure should take into account the possibility of arrears accumulation, which may challenge future fiscal performance. As to the monetary and exchange rate policy, I support the authorities' intention to continue their existing strategies and encourage the authorities to maintain their hard-won achievement in price stability through exchange rate policy.

Fourth, even though I appreciate the authorities' determination and believe that the new government is strongly pro-reform and relatively independent of the traditional vested interests in Russia and that the support of the president as well as parliament in important areas has been forthcoming, I am still deeply concerned about whether implementation of the program can be effectively enforced. On one hand, I agree with the staff view that the government will have to resist pressures from strong interests in regional and local governments and in enterprises, and the fiscal problems have proven difficult to solve. Therefore, the risk to the program should not be underestimated. On the other hand, judging from Russia's track record in program execution, one cannot but feel little secured to forecast the outcome of the program. It is particularly precarious to make any assessment based only on a policy announcement or issuance of a decree in addressing the deep-rooted fundamental problems. It is correct to believe that our judgement on the policy adequacy should not depend on the announcement of policies or measures, but the actions taken, and actual performance of the program. We all know, deeds are more important than words. Therefore the authorities are urged to undertake a thorough and effective implementation of the program. We can endorse the staff view that the Russian authorities themselves should convince the market that their policies are enforceable and their fiscal position is sustainable in the medium term and that their overall deficit can be financed. In addition, I have to say that even the Fund itself is now undertaking exceptional risks in Russia.

In conclusion, I wish the authorities success in their future endeavors.

Mr. Giustiniani made the following statement:

When this Board discussed the seventh review of the Stand-By Arrangement, this chair emphasized that to deserve and obtain additional Fund support, Russia was expected to take bolder policy measures. The objective was to rebuild confidence in the government's solvency, the stability of the ruble, and the long-awaited economic recovery. The government presented an anticrisis plan aimed at reducing the fiscal imbalance through a sustained improvement in cash revenues following a deterioration of public finances recorded during the program. This was an important step in the right direction. However, a recalcitrant Duma rejected most of the government's deficit cutting measures. Some of them had to be enacted by presidential decree; some others will be discussed in a parliamentary session in August. Therefore, prior actions have not been completely met. The action taken by the Russian government clearly demonstrates its willingness and commitment to overcome the crisis situation. However, we are concerned that the Russian government and the Russian parliament still continue to be at odds, despite the deep crisis

in Russia. The reform process is not underpinned by adequate ownership. We wonder what the chances are that the program will now be fully implemented.

The envisaged additional financial support is heavily frontloaded, while policy implementation is largely backloaded. Furthermore, the program will generate limited budget improvements this year. The fiscal performance in 1998 will crucially depend on the government's capacity to obtain funds from the country's main tax delinquents, namely the large corporations. The efforts to strengthen tax revenue on a sustainable basis will bear fruits only in 1999, and provided that the program is fully implemented. This objective remains questionable, not only because of the above-mentioned political problems, but also because of the downturn in economic activity foreseen this year.

Staff projections seem optimistic, as some private institutions foresee an output contraction of 3 percent this year, and barely any growth in 1999. The reason for the current state of the economy can be traced to the high level of uncertainty surrounding the economic and political future of Russia that has paralyzed investors.

An additional element of risk stems from the financial fragility of the banking system and from the decision of the Central Bank to provide liquidity assistance to facilitate the merging between healthy and unhealthy banks. An excessive injection of liquidity into the system would generate a further strain on Russia's already limited official reserves, and put pressure on the exchange rate. The lack of information on banks' foreign currency position, especially on off-balance sheet instruments, makes the picture even more gloomy.

There is a credibility problem about the external value of the ruble, as is evident by the market behavior. If the government does not act promptly to rebuild confidence and to improve the situation of its finances, no amount of official reserves will be able to ensure the stability of the exchange rate.

To finance the succession of the program, the Fund has to borrow from the GAB for the first time in more than 20 years. The G-10 countries and other countries whose currencies are included in the operational budget are bearing the burden of the financing. We think this is justifiable given the exceptional circumstances we are facing as an organization. Nonetheless, we would have expected a more active role of some other member countries.

It is of paramount importance that the additional financing coming from the Fund goes to replenish the stock of official reserves. A more comfortable level of foreign exchange would increase market confidence in the stability of the ruble. Given the risk surrounding the fiscal effort that have been made and the noncooperative behavior of the Duma, the possibility of rephasing purchases in the initial phase of the program should be considered. We see important merits in Mr. Kiekens's proposal, and would be ready to support it. As a matter of fact, we were wondering whether a monthly tranching would be appropriate in this case.

Keynes said something along the following lines: if you owe 100 pounds to a bank, it is your own problem, but if you owe 1 million pounds, it is the bank's problem. This is exactly the situation with Russia. If Russia fails, the Fund risks failing as well. Therefore, the Russian government must be fully aware that it is assuming an additional and burdensome responsibility vis-à-vis its own people and the international community.

Mr. Kiekens agreed with Mr. Giustiniani and other Directors that a sustainable fiscal adjustment should be a condition for support of the program. The absence of information on the currency exposure of the banking system in Russia was worrisome because it prevented Directors from having a clear assessment of the contingent public finance liability for banking restructuring.

The assessment by Mr. Giustiniani that the program was heavily front-loaded in disbursement and back-loaded in the implementation of measures was correct, Mr. Kiekens considered. The more front-loaded the disbursement, the weaker was the Fund's leverage to force implementation of the program. Mr. Giustiniani's proposal to rephase payments was justified, and the 10-day proposal for rephasing was perhaps too timid.

Ms. Lissakers made the following statement:

As reflected in the preceding statements by my colleagues, we are being asked today to take a decision fraught with risk. I think that both the staff report and Mr. Mozhin's statement note the risk quite forthrightly. None of us can say with certainty that the effort will succeed, but we at least are persuaded that the risk is worth taking.

Supporting Russia's transformation has been one of the Fund's pre-eminent challenges and tasks in this decade. Looking at the broad record, much has been accomplished, including price liberalization, the rapid privatization of Russian industry, the dramatic lowering of inflation from the high levels of the 1992-95 period to low single digits presently, the anchoring of the ruble, and the development of an active government securities market. We always understood that the road to reform in Russia would be rough, and Russia certainly has not disappointed us in this regard.

It is true, as Mr. Mozhin observes, that this year Russia in part has been a victim of bad luck. The Asian flu and falling oil and commodity prices have hurt the balance of payments, and the request for the CCFF drawing is justified under those circumstances. But we also understand that these external shocks have only exacerbated the larger underlying problems of an under performing economy and fiscal fragility, which, despite repeated corrective efforts, persist.

I have observed repeatedly that a flawed tax structure is at the heart of weak revenue performance. Finally, in recent weeks, Russian authorities, including President Yeltsin himself, have accorded permanent legislative reforms the emphasis and the urgency long needed. Last week, at long last, the Duma delivered at least part of what is needed: most importantly, the approval of the first part, Part 1 of the tax reform code, secondly, the passage of the

budget reform code; and third, the many other tax measures that have been referenced.

Surely, all of us, including the Russian government, would have liked to see the Duma do more. The necessity once again for the authorities to resort to presidential decrees in lieu of actual legislation is cause for concern and raises some doubts about Russian ownership of the program. In this light, I think it is correct that the authorities reduced their request with regard to the size of today's proposed purchase.

We all recognize that an augmented Fund program will provide only temporary respite from financial crisis if the rest of the revenue and spending reforms do not materialize later this year. Government finances have been increasingly burdened by the need to roll over large GKO obligations weekly, with interest payments an ever-larger part of the fiscal burden. This, of course, reflects diminished investor confidence, which can only be restored by credible permanent fixes to Russia's structural problems.

Certainly, the proposed refinancing into longer maturities of foreign currency denominated debt can take some of the immediate pressure off the budget. But I agree with my colleagues' expressions of concern about the implications of the larger external debt exposure Russia is assuming in the process. Restructuring debt alone will not suffice, of course, especially if deficits continue to accumulate and confidence remains low. Therefore, the Fund program seems to achieve a significant primary budget surplus. Together, the debt restructuring and lower deficits should lessen pressures on capital markets, reduce interest rates generally in the economy, and cut into the large and growing interest burden on the deficit. I think this is laid out very clearly in the figures on page 39 of the staff paper, which I thought were quite useful. I think it would also be useful if the staff could provide us with an updated chart of that nature to reflect the interest rates and the size of the GKO conversion, so that we see what the results of this Friday's exercise will be.

The authorities recognize that there is not much more blood to be squeezed from the stone of government spending, and finally appear to be making a serious bid to raise revenue. On tax administration, we are pleased by the movement on Part I of the tax code, as I said. But this, of course, is only a skeletal framework that needs to be augmented by the other parts and tax policy reforms in order to change the incentive structure for tax paying. We certainly welcome the efforts to consolidate tax organizations under the STS. But the authorities' existing and still disappointing tax administration efforts must be kept under close watch. Paragraph 10 of the letter of intent focuses on strengthening the large taxpayers unit. We seem to have heard this before. I am also concerned that second-quarter revenues fell short, even though the target was just revised downward, and that prior actions for the seventh review, particularly oil pipeline access, appear not to have been clearly met. We wonder if Mr. Mozhin's big fish are yet in the net.

On tax policy, the program includes a wealth of measures aimed at increasing revenue collection and making for a more effective tax structure.

While I think Mr. Kiekens is right to point out how much of the 1998/99 improvement in fiscal performance depends on politically sensitive expenditure cuts, I would point out that the table at least projects what one hopes will be an important improvement in cash collections of revenue, which would rise from 9.7 percent of GDP in 1997 to a hoped-for 13 percent of GDP in 1999. That, in itself, would reflect a very significant change in the nonpayment culture, presumably throughout the economy, if the authorities carry that through.

We certainly share the staff's regret that the authorities have resorted to an import duty surcharge to help to fill some of the budget gap. We strongly commend the effort to introduce conditionality into the federal transfers to regions, and hope this will lead to a clearer definition of roles and responsibilities. I wonder if the staff could elaborate a little bit more on whether responsibility for delivering public services is also being decentralized in the process of trying to redistribute the taxation responsibilities and shares between the federal and lower level governments.

In terms of measures regarding the enlarged government, it strikes me that some of the proposed actions, especially regarding the pension fund, will be very difficult politically. This is an area where we hope the government will take full responsibility and work as aggressively, as it did in the last couple of weeks, to try to push through the necessary legislative reforms when the Duma returns in August.

The effort to bring extra budgetary accounts into the budget and to eliminate earmarking for the road and social insurance funds are certainly welcome. But I continue to worry about the Treasury. Paragraph 26 of the staff report suggests that the military would be brought under the Treasury over the course of the year, whereas only a month ago we were told that this would already happen by the end of the third quarter. Also, I wonder if the staff and/or Mr. Mozhin could assure us that the policy of no offsets remains firmly in place.

The shifting of the value-added tax to an accrual basis and strengthening of bankruptcy procedures and measures by energy firms to cut off nonpaying customers does signal an important effort to de-emphasize barter and improve the cash payment pattern. But I do not think we are nearly as far on this road as we had expected when we agreed to the previous program.

On the banking front, we were pleased that the central bank is becoming increasingly transparent. But we certainly share the staff's concerns regarding the level of liquidity support to facilitate the merger of weak banks with healthy banks. As we have seen in other countries, experience suggests that such an approach to banking restructuring merely dilutes the strength of the banking system as a whole, rather than solving the problem. It would be far preferable to close down weak banks.

Further on the banking issue, I wonder whether the staff can confirm that it is, in fact, receiving all of the information it has sought about the

activities of the Sberbank and other state-owned banks, including their foreign entities, external foreign currency assets, and liabilities.

In supporting the program, we have noted that it is well designed, but, of course, well-designed programs have been presented to us before. The key is for Russia to fulfil the specific elements of the program. Russia's track record, the Duma's rejection of some key legislative pieces for the program, the resort to decrees, and also the murky relations still between regions and the center do give one considerable pause. We have no doubt about the authorities' full commitment both to the anticrisis program and to larger and permanent structural reforms. I think the authorities are certainly well aware of the high stakes involved. A devaluation of the ruble would be a major blow for the stabilization gains in recent years, and would surely send inflation higher, rip a huge hole through the financial system, and undermine confidence in Russia's leadership.

The enhanced resources that we are extending today cannot ensure stability, nor do they constitute an effective use of resources in and of themselves. They can only be effectively used to bridge to the period when a strengthened program kicks in with force and helps put Russia on a steady growth path. This course will only be navigated successfully if Russia fully owns and implements the enhanced program. I think the publication of the letter of intent and the memorandum of understanding is an important step in this regard. I think the Fund, as well, should issue a summary of the Board's discussion so that we too are fully transparent about our actions and decisions.

Mr. Taylor made the following statement:

The Fund should adopt monthly tranching of payments, and it would be appropriate at the current juncture to withhold the Extended Fund Facility (EFF) for at least 10 days as suggested by Mr. Kiekens.

The critical aspect now is implementation. I hope the staff will take some notice of what Mr. Sivaraman said about the need to organize a broad ranging structural reform program.

Mr. Kiekens has pointed to the problem of the lack of real structural reform in the fiscal area when the inevitable further depreciation occurs. The real structural problem is governance. The disregard for paying amounts due is only one aspect of a much larger governance problem in Russia.

The creditworthiness of the Fund itself now is of some concern and needs to be carefully considered. The Fund has at least two extremely large borrowers where the odds would indicate that money may not be paid back on schedule.

The Director of the European II Department noted that Executive Directors had had many discussions about exchange rate policy and whether or not currencies could be defended. The conclusion of those discussions had pointed out that currencies could be successfully defended only when the underlying fundamentals were consistent with the

exchange rate of the currency. The purpose of the measures in the Russian program was to ensure that the fundamentals were consistent with the position of the currency. The staff did not have any problems with the level of the exchange rate from the point of view of the current account balance. Russia's exports and imports remained competitive, with one exception. The terms of trade shock which hit Russia as a primary commodity exporter did in principle create a case for some depreciation of the currency. At the same time, if the program were successful, there could be renewed capital inflows, which could create some room for an appreciation. At that stage, one should avoid upsetting market expectations by hinting that there might be a change in the exchange rate regime. A move toward somewhat greater flexibility might make sense in the future, once confidence had been reestablished.

The effect of macroeconomic fundamentals on capital flows depended on the perception of investors about the sustainability of policies in Russia, the prospects for growth in the economy, and the attractiveness of the environment for investment, the Director continued. The program was directed at improving the fundamentals in those areas so that the current exchange rate could be sustainable.

Capital flows closely followed perceptions of investors about the fundamentals in the economy, the Director observed. There had been significant capital outflows in the past six months because of doubts in that area, but there had also been large capital inflows in the first half of 1997.

It would be useful to look at reserves in relation to balance sheets and capital flows, as well as in relation to current flows such as imports, the Director considered. One single meaningful indicator could not be used, because balance sheets were deceptive. In the case of Russia, neither foreign currency debt nor short-term debt was the principal concern, but rather the domestic-currency-denominated liabilities of the government. The staff was trying to improve its knowledge of balance sheet vulnerabilities in crucial countries. That was certainly being done in the case of Russia, and more such information would be provided to the Board.

In reaching a decision on why the September tranche was not conditional on the Duma passing amendments to Part I of the tax code, the staff had taken into consideration that the tax code was a politically sensitive issue, the Director explained. It was not optimal to go back to the Duma with amendments to the tax code, to avoid provoking a hostile reaction.

The staff had not given consideration to delaying the first tranche of payments for 10 days after the presidential decrees for two reasons, the Director added. First, the staff believed that the Duma would acquiesce to the presidential decrees. Second, the staff considered it important that the first tranche should show substantial financial support for the program to reassure markets that the central bank had sufficient reserves in the event of further uncertainties in the markets.

Monthly monitoring had not always been successful in Russia, and in fact had some disadvantages, the Director noted. First, it encouraged a short-term orientation among policymakers and in the Fund, which was unhelpful as it was possible to lose sight of the underlying changes that were needed. Furthermore, the authorities became dependent on the staff, and a loss of ownership resulted from that process. A three-month monitoring period caused the authorities to be more inclined to take charge of problems themselves, thereby increasing ownership.

The Deputy Director of the European II Department commented that the fiscal adjustment was equally weighed on expenditure reduction and on revenue increases.

While the policy had been that there were not going to be any more tax offsets, the staff was monitoring to ensure that offsets were not appearing in the tax laws, the Deputy Director said. The staff had made it clear to the government that any offset would automatically be a violation of the program.

Plans for dealing with large delinquent taxpayers existed, as evidenced by the recent action taken with respect to Gazprom, the Deputy Director pointed. Gazprom had agreed to pay all of its taxes on a current basis, although the disposition of arrears was still pending because of the need to collect additional information. In trying to correct its tax arrears problem, Gazprom had cut services to other parts of the population, and put pressure on hospitals, the army, and the provision of municipal services, such as heating and hot water.

The 1998 expenditure control plan contained provisions to eliminate certain public expenditures, particularly transfers to regional and municipal governments to fund social expenditures, the Deputy Director explained. A tripartite commission, formed by the Duma, the government, and the Federation Council was looking at local and federal issues. One focus was to take into account expenditure responsibilities and revenue potential in determining federal transfers.

Money velocity in Russia was high, the Deputy Director noted, principally because there was still mistrust in the banking system and expectations of exchange rate changes. It was therefore important to continue to make progress on bank restructuring and on inflation reduction.

The letter of intent included a plan for devising a comprehensive approach for addressing problem banks, the Deputy Director stated. That strategy might imply the creation of a bank restructuring agency, and the World Bank and the Fund were ready to support that. Data on Sberbank and other official banks were being provided to the staff, and additional data on the Sberbank would be provided to management on a confidential basis. The central bank agreed to have an internationally recognized consultant study the relationship between the central bank and Sberbank to determine what types of fire walls could be set up to ensure independence of the Sberbank while protecting the rights of the central bank as a shareholder in Sberbank.

On the debt conversion scheme, the amount accepted for exchange was about Rub 27.5 billion, and bonds issued amounted to Rub \$6.4 billion at a spread of 940 basis points, the Deputy Director reported. While the spread was quite large, one needed to take into consideration that a large part of the debt conversion would be done on zero coupon notes with maturities of less than one year (GKO's) falling due before the end of 1998. The alternative would be for the government to renew GKO's at rates of interest of 50 percent. The current debt conversion policy would result in a large burden in the long run, but in the current circumstances it was justified because of its contribution to the overall package.

Mr. Yoshimura considered that the program in Russia had substantial uncertainty associated with it, and that monthly monitoring might therefore be justifiable. Could the staff comment on what part the private sector could play in burden sharing?

Ms. Lissakers considered that the degree of monitoring depended on what was being monitored. In the case of Russia, monitoring was concerned with the delivery of long-term structural reforms rather than short-term macroeconomic performance, and quarterly monitoring would likely suffice.

Mr. Esdar noted that at the current juncture the performance of structural decisions was important, and agreed with Ms. Lissakers that quarterly monitoring was more appropriate.

The debt conversion scheme maturities of 20-year duration with spreads up to 940 points generated some doubts about participation of the private sector in solving the problem, Mr. Esdar considered. Could the staff perhaps indicate whether it was external creditors or internal GKO holders who contributed to the systems?

Mr. Eyzaguirre commented that if the Fund recommended an exchange rate policy aimed at the stability of the exchange rate, it would make sense to move government debt from domestic currency to foreign currency. The only problem with that arrangement would be that if indebtedness increased, it would be less possible in the future to exit the peg. If the ruble were not allowed to fluctuate, it would be important to have strong prudential regulations in the financial sector to avoid over-borrowing in dollars.

Mr. Giustiniani said that he shared Mr. Yoshimura's concern about the participation of the private sector, and considered that the debt conversion scheme made the program more vulnerable because debt was now denominated in foreign currency, which provided insurance to the private sector against exchange rate changes.

Ms. Lissakers wondered whether the 20-year bonds had a callable feature.

The Deputy Director of the European II Department responded that the bonds did not have a callable feature because such a feature would have made it appealing only to a small niche of the market.

All participation in the debt conversion scheme was intended to be private, although it was not clear how much was domestic and how much was nonresident, the Deputy Director explained. Neither the Sberbank nor the central bank was supposed to participate in the debt conversion scheme, but the Sberbank had been considering whether to convert part of the GKO's into longer maturity domestic currency bonds.

Mr. Askari-Rankouhi noted that the staff considered that the first tranche payment had to be large to reassure markets. However, recent experience of other crises showed that no amount of money would reassure markets if the required measures were not in place. In the case of Russia, even a large tranche might not be sufficient if the reform measures were passed. He wondered whether the staff could comment on what impact Part I of the Tax Code had had on revenues.

The Deputy Director from the European II Department recalled that Part I of the Tax Code had never been intended to have a large impact on revenue. The intention of the Tax Code was twofold. First, to increase efficiency in the economy, and second, to provide a more orderly tax system that would permit stronger tax enforcement.

Mr. Esdar wondered whether the staff could comment on the market reaction to the postponement of disbursements.

The Deputy Director of the European II Department noted that since July 16 GKO yields had dropped by 10 percent. However, various developments had occurred since then, and one could not attribute the whole drop only to the debt conversion scheme.

Ms. Lissakers wondered whether the Duma had passed an imputed minimum tax for small- and medium-sized enterprises, and if so, what effects it could have on revenues.

The Deputy Director of the European II Department responded that the imputed tax could provide some revenue, but needed to be implemented in a careful way. The staff was not, however, assigning a large revenue yield to the imputed tax.

The staff representative from the World Bank stated that cost recovery in enterprises could not have been much more ambitious. The phased-in program on electricity, gas, and rail was quite a challenging endeavor for the government and the enterprises to implement. A more ambitious schedule would likely test the fabric of the social safety net.

The Fund's program relating to Gazprom was part of a larger structural program of the Bank's third structural adjustment loan, the staff representative noted. The objective of the program was to create separate subsidiaries and independent management in Gazprom, which was key to engender a competitive restructuring of the gas market. The program included a tax on monopoly producer rent to provide greater access to markets and to establish a level playing field for the independent gas producers. Furthermore, the program established that independent gas producers would no longer be subject to price controls.

Mr. Kiekens welcomed the program's measures. He wondered whether access to the Gazprom pipeline would also be available for foreign producers in the region, such as Turkmenistan and Kazakhstan.

The Director of the European II Department replied that usage of the Russian network was renegotiated every year. Those negotiations would continue between foreign suppliers of gas who want to use the Russian network and Gazprom or whatever successor organization would take over responsibility for the transmission network.

The staff representative from the Policy Development and Review Department noted that a Fund member was entitled to draw up to the annual access limit before turning to the SRF. The annual access limit was 100 percent of the quota. In the case of the Russia program, 50 percent of the quota was still available under the EFF before turning to the SRF. That amount had been spread evenly in the tranching.

Mr. Giustiniani wondered whether the staff could provide some information on the rollover of the Russian external debt.

The staff representative from the European II Department noted that commercial banks continued to fulfill their obligations, but no specifics were available about a rollover at this time.

Mr. Guzmán-Calafell made the following statement:

The crisis of confidence that has affected the financial markets in Russia during the last months is hardly surprising. The failure of the authorities to tackle the existing imbalances has led to growing uncertainty on the economy's outlook. This has combined with a deterioration of the external environment and a number of adverse political events, to produce a situation which has been perceived by markets as unsustainable. The difficulties have worsened further as the policy response has relied almost exclusively on the increase in interest rates. In this context, economic activity has resumed a downward trend, the fiscal deficit has remained at excessive levels, the banking system has weakened substantially, and the government has faced increasing problems to obtain financing in the domestic and international markets. Moreover, the need to intervene in the exchange markets in defense of the ruble has reduced international reserves to dangerous levels.

It is clear that the only possible way out of a situation like that the Russian economy is undergoing, is the steadfast implementation of a program of adjustment aimed at tackling the root causes of the problems faced, combined with external financing in sufficient amounts to strengthen market confidence on the authorities' capacity to meet their external commitments. I believe Russia's enhanced economic policy package is adequately supported by external financing, and concentrates in those areas where actions are more urgently needed, namely, a major fiscal adjustment in 1999, a strengthening of the efforts of structural reform with special attention to the need to solve the nonpayment problem and to foster private sector activity, and measures to lengthen the maturity of government obligations. In addition, the program is underpinned by a long list of prior actions which ensure that a number of adjustments are carried out up-front. But as many Directors have noted, rather than the quality of the program itself, the central question in this case is if it is going to be implemented in full.

The recent experience does not give much grounds for optimism in this regard, since the track record of policy implementation in Russia is poor. But it is also true that there are a number of new elements which may make the situation different this time. Ownership of the economic program seems to be strong at the government level. The authorities' decision to lay out the fiscal targets and policies for 1999 in a Presidential Decree and a Presidential Address is a welcome indicator in this respect. I am also encouraged by the staff's view that the current government is strongly pro-reform and relatively independent of the traditional vested interests in Russia. Mr. Mozhin provides in his useful buff statement a number of additional arguments supporting the idea of a solid government's commitment to implement the program. The authorities' recognition that transition to a market economy will take longer than initially expected, and the consequent intention to seek a new EFF for the period 1999-2001, represents another positive indicator of the future course of economic policy in Russia.

Nevertheless, even under the assumption that the government will do everything at their reach to carry out the policies agreed under the enhanced

economic policy package, the risks remain substantial. The external environment may deteriorate further, the situation of the banking system is fragile, and very importantly, as evidenced by the difficulties observed to obtain parliamentary approval for a number of prior actions, ownership of the program beyond the government level is weak.

This poses a complex situation for the Fund, given the high level of exposure with Russia. Under the assumption that all purchases are made as proposed, total liabilities of Russia with the Fund will reach 26 billion dollars this year, a figure equivalent to 93 percent of the projected level of international reserves, and as Mr. Giustiniani pointed out, more than 30 percent of the Fund's exposure under the GRA. Furthermore, it is not only the credibility of the Russian government that is at stake if the program is not implemented as agreed, but also, as noted by Mr. Esdar, that of the staff and the Board.

With all these elements in mind, the central question is if the potential benefits of the Fund's support to Russia outweigh the accompanying risks. In my view they do, and therefore I am willing to give the Russian authorities once more the benefit of the doubt.

I support the proposed decision and I wish the Russian authorities every success in overcoming the difficult challenges ahead.

Mr. Yakusha made the following statement:

There is an urgent need to restore confidence in the Russian economy. Given the potential domestic and external effects of the further deterioration of Russia's debt service capacity, and against the background of the precarious liquidity position of the Fund, we endorse the activation of the GAB for the financing of the Russian program. The funds to be made available under the GAB should be regarded as a bridge loan until the Eleventh General Review of Quotas goes into effect. The present situation underlines the importance of the quota increase.

Restoring international confidence in the Russian economy will not be an easy task, given the rather unfavorable track record of the Russian authorities. We therefore underline the importance of a strengthening of the authorities' commitment to address the structural problems in the field of government finance, financial sector impediments to private sector development, and trade liberalization.

While welcoming the implementation of prior actions, we are concerned that the implementation of some important structural reforms fell short of the program objective. As Table 4 of the staff report suggests, 14 out of 30 structural measures have not been implemented in full as of the end of June. Despite quite serious new reform measures and commitments that have been undertaken by the authorities recently, the impact of the neglect in other structural reforms should not be underestimated. We urge the authorities to catch up with their previous commitments on the structural side by the time of

the next review. Could the staff update the Board on the implementation of both new and old measures on a monthly basis.

Carrying through the political commitment to address the underlying economic problems and the manner in which the Fund program is implemented plays a much more important role in restoring the confidence of international financial markets than the announcement of large packages themselves. This is a lesson that has been learned from the Southeast Asian crisis.

Consistent program implementation and strengthening of monitoring are also vital to preserve the credibility of Fund involvement and to safeguard the Fund's substantial exposure in Russia. The financial package would only offset the impact of lower export prices and the recent hike in debt service. Without consistent implementation of structural reforms, the Russian authorities may soon find themselves again in an unsustainable fiscal position.

The crucial issue remains the strengthening of the tax collection and prudent expenditure management. We are encouraged by the authorities' intentions to depart from the practice of transferring resources to the spending ministries and to implement the treasury control mechanisms. We welcome the intentions of the authorities to exercise more control over expenditures of extra budgetary funds and of the local governments.

The proposed scheme of creating incentives for dependent territories to comply with federal revenue collection and spending guidelines is a welcome measure. Further increases in cost recovery on housing and communal services, as well as strengthening of the subnational debt management and monitoring, also constitute steps in the right direction. We share the concerns over shifting too much of the tax burden from enterprises to households, which may weaken the public support for reform. Public reaction to the revenue measures could be mitigated by arresting the growth of budget, wage, and pension arrears and by reducing the stock of arrears as soon as possible. Further efforts should also be made to increase transparency of the spending programs.

The banking sector's vulnerability has increased in the past few years, especially in recent months. The assessments by credit rating agencies, like that of Standard and Poors as of June 10, seem to indicate that many Russian banks might be depending too much on dollar-denominated short-term borrowing. Could the staff give more detailed information on the action plan for large problem banks and indicate the likely impact of these measures on the budget deficit.

The letter of intent described measures to be undertaken by the Russian authorities in order to improve competitiveness and data disclosure of the banking sector. Could the staff comment on the adequacy of the proposed actions.

We reluctantly endorse the proposed measure on the import surcharge. Uniform application of this surcharge would contradict the provisions of some bilateral trade agreements signed by the Russian Federation. It would be useful

if the staff could keep the Board informed about the impact of this surcharge measure.

With these remarks, we support the proposed decisions.

Mr. Cippà made the following statement:

The negotiations between staff and the Russian authorities have resulted in a proposal for additional substantial financing which in terms of calming the markets and taking pressure off the ruble has already had the desired effect. The program is ambitious with regards to both the envisaged policy measures and the schedule for their implementation. At this stage I will not discuss again the program in detail. I very much agree with most of what has been said by Mr. Kiekens and Mr. Askari. Let me also say from the outset that, though reluctantly, I support the proposed decision.

Instead, I would like to concentrate my remarks on some elements of uneasiness that I and my authorities feel about today's discussion. Given the scale and importance of the matter, the Board is clearly left with too little choice too late. When dealing with a crisis situation, the Fund's actions appear to become all too easily predictable for market participants. In the Russian case, the markets started to anticipate an IMF support package as soon as the unsustainability of the government's macroeconomic policies—exacerbated by legal and institutional shortcomings—became obvious. As we should be aware by now, this presents an invitation to private creditors for ignoring well known risks not just in Russia but in other emerging markets as well. This has raised the stakes for disappointing market expectations and increased the likelihood for triggering a severe financial crisis of regional if not global proportions.

Another point of uneasiness regards the participation of the private sector. In the past few months and weeks, the importance of the so called "burden sharing," by involving the private sector in preventing and resolving currency crises has frequently been emphasized. I cannot help the feeling that in the case of Russia the staff is not acting accordingly, since it is proposing a program where the private sector is not entering the stage, or bailed in, as candidly admitted by Mr. Marques-Ruarte. Instead of aiming at a debt rescheduling with the participation of private creditors, the Russian authorities are using vast amounts of public money to stabilize the ruble, thus bailing out private creditors by securing their ruble denominated loans. The authorities even offer the holders of short-term GKO to convert their short-term ruble bonds into longer term dollar-denominated bonds. Even though the offer makes economic sense by reducing both the weight of servicing the debt and the maturity risk of the credits, in terms of "burden sharing" it runs counter to the Fund's proclaimed aims. I fail to understand the rationale behind the Fund's public support of this strategy which amounts to bailing out private short-term creditors at the expense of the IFI's. We are thus about to create a very dangerous moral hazard problem by inviting investors to conclude that they can lend to Russia or any other similarly big and important country without fear of default or any significant exchange rate risk, as already said by Mr. Giustiniani. Moreover, we should have learnt from the Asian crisis that

excessive unhedged foreign currency exposures bear the risk of dramatic consequences.

The credibility of the IMF is also something we should take care of. Even though the Russian program is ambitious, in many respects this is yet another, stepped-up edition of past IMF infusions to Russia. All three past attempts since 1993 have failed to improve the fiscal situation and to ignite crucial structural reforms. I welcomed Mr. Chubais' explanation during lunch of why the situation is different this time than in the past, but as always when we speak about commitments there is no clear evidence why this program should be successful and lead to the expected results. And I do not think we should be too surprised that the public is drawing the conclusion that the IMF is acting under heavy political pressure, perhaps against its own better knowledge and conviction and is left with no alternative to throw good money after bad. I am concerned about the consequences such a behavior will have for the future of our institution. I fear that if we fail again, the Fund is bound to lose a lot of goodwill, prestige and—above all—credibility.

And finally, it is reasonable to question whether the program is in the best interest of Russia itself. Of course, nobody should underestimate the risk of a destabilized Russia, but with this financial package we are once more easing the market pressure on Russia's political elite to swiftly implement long overdue structural reforms.

As stressed by many colleagues, the crucial factor here is implementation. And we must make sure that conditionality is applied strictly. Staff provided us today with important information about what parts of the reform catalogue, which served as prior actions, have passed the Duma, which part will merely be imposed by decree and how reversible all these decisions are. All in all, I must say I am rather disappointed by the outcome of the Parliament discussion. I can only admire Mr. Odling-Smee's optimism, but given their previous poor record of advancing legal and institutional reform, the Russian government and parliament must be strictly judged by their actions.

For this reason, I welcome the rephrasing of the disbursement to take into account the failure to pass legislation of personal income tax. I am prepared even to go a little bit further and support, as already indicated by Mr. Kiekens, to wait 10 days with the first disbursement until the presidential decrees can no longer be overturned; just to be on the safer side. And even if the possibility for the Duma to try to challenge presidential decisions is very small, I think that this proposal embodies a strong message to the authorities that conditionality must be fully implemented before any further step will be taken by the international community. As far as monthly tranching is concerned, I take note of the disadvantages of such practice and can follow staff's suggestion not to retain it.

To conclude, I think we all agree that today's discussion raises issues which go beyond the case of Russia. In this respect, it is urgent that we provide answers to some basic questions, concerning the role of the Fund in preventing and dealing with similar crises. The upcoming deliberations on the new

architecture of the international financial system will be the appropriate occasion to look ahead. Meanwhile, I wish the Russian authorities every success in their difficult endeavor.

Mr. Hansen made the following statement:

The circumstances with which we are surrounded today do not inspire me to go deeply into the macroeconomic aspects of the Russian economy. Russia is already among a handful of countries whose economic situation is known very well to us, due to many discussions in this Board, with the last discussion as recently as less than a month ago. Instead, now the circumstances require that we once again look at Russia, but in a substantially different perspective than before.

Only a few weeks ago Fund management was assuring world financial markets, that contrary to what markets and commentators were thinking, there was no reason to panic about Russia. Today we know better. The Fund sent a wrong signal, and by the end of this year, the Fund will be exposed in Russia to the tune of more than \$26 billion. I concur with Mr. Giustiniani's remark on the Fund's growing dependency on Russia. One could also say that the ruble is certainly the Russian currency, but it has become our problem.

During the recent past Russia appeared to be a country challenged by huge difficulties in its transition process from a planned to a market-based economy. While its sheer size made rapid improvements more difficult than in other transition countries, it is evident that there has never been a full consensus around the required reforms in Russia. Many previous reforms haven't been fully implemented due to many reasons, among which weak public management, problems of governance, and absence of the rule of law stand out high. Well-prepared programs and intentions may have always been there, but the necessary domestic support to the reform-minded authorities was always in deficit. Nevertheless, Russia's integration into the global financial markets was fast and extensive. It lured large amounts of capital, whose owners were excited by high returns and Russia's perfect fit into their diversification strategies. This development created a base for the appearance of a moral hazard situation around Russia. Financial agents until recently were too complacent in light of adverse developments in the Russian economy. There has been a wide-spread belief in the markets that the Russian economy was too important for the international stability to fail.

Today, Russia should, first of all, be seen in this wider prospective. It is a country faced with a major crisis which, if happened, might bring not only Russia, but the entire global economical, financial and political stability to the unknown. This unknown looks too dark to take a risk to have even a short glance into it.

I agree with those who think that a major question in making a decision today on supporting the program is whether the situation in Russia is more promising now than it was before. One positive thing is that if the Fund's

assistance helps to avert crisis (and we all believe it will), the situation at least will not deteriorate, and things can only get better.

However, the current situation is that of an emergency, with high risk of systemic crisis if the Fund's financial assistance is not provided. It is against this background that our chair supports the revision of the program for 1998 and an increase in access to the Fund resources. I continue to believe that valuable time has been lost because of lack of implementation of the original EFF. Gaining a full ownership by all levels of power of the revised current EFF and the upcoming new one, coupled with a strict implementation of the performance criteria, is of utmost importance for securing lasting progress in the Russian economy, as well as stabilizing financial markets.

Putting aside some of my concerns about the past experience of incomplete reforms in Russia, I welcome implementation of several important prior actions, which add a strong weight on the positive side of the decision scale. I hope that conflicting views within the circles of power are forgotten for the time being, and joint efforts will be directed to move Russia away from the edge of collapse. I also hope that the Presidential and government decrees will ensure collection of adequate budget revenues to guarantee achievement of the set targets. However, once again, it is obvious that less than a full consensus exists in Russia on the reform developments. The problem here is that the sustainability of reforms, and of the entire transition process to that matter, comes only in full packages. If something is left out of the package, the whole chain starts breaking. Let me emphasize that any extension of this revised EFF in the future will be based on Russia showing a highly satisfactory track record in implementing the program.

There is no doubt that we want to see Russia as an economically prosperous country and a good trading partner. In this respect, it should be strongly emphasized that Russia has to keep an open and transparent trade system, for both goods and services, including financial services. Russia also has to avoid application of discriminatory economic policy measures vis-à-vis all its trading partners. Those are important preconditions for the extension of this extraordinary level of assistance by the international community.

Mr. O'Donnell made the following statement:

It is not sufficient for actions to be passed by the Duma, they must also be implemented. Some of the proposed measures, for example, moving to a broader based sales tax, involve new and difficult collection problems, and I wonder how robust the extra revenue targets will be.

The largest fiscal measure is the conversion program, which appears incredibly expensive. Russia is locked into a 20-year obligation at 940 basis points over the U.S. rate. That seems to be a guarantee for medium-term fiscal problems.

I am worried about the banking sector. One of the lessons of the Asian crisis was the problem about uncovered foreign exchange positions of banks. I

have seen estimates that uncovered positions could be as high as \$10 billion in Russia, against a capital base of around \$30 billion. Can these positions be sufficiently hedged? If not, suggestions about flexibility of exchange rate policy seems to be misplaced because it will be too expensive to move in that direction.

There is not much of credibility about the reserves figures in the market place. It would be useful to enhance their credibility and transparency.

The rephrasing of payments is a sensitive issue. On the one hand, if a 10 day delay is imposed, markets will be worried because they will infer that not much money is available. On the other hand, they might be reassured if they believe the Fund is taking a stricter attitude toward program implementation. I would be willing to trust the staff's view on this matter, as long as I am convinced it has made its best possible judgment about the balance of those two factors.

If previous experience in Russia suggests that quarterly monitoring performs better than monthly monitoring, I can support that position.

Mr. Kiekens said that he agreed with Mr. O'Donnell that the markets were worried about the external reserve figures. The main reason for that was that the central bank only published gross reserves, not net reserves.

The Director of the European II Department recalled that the staff had had long and detailed discussions with the central bank about suspicions in the markets concerning the reserve position. The central bank had provided the staff with a great deal of data, and it appeared that the markets were greatly exaggerating the problems of the reserve position.

Messrs. O'Donnell and Sobel considered that the central bank could move to a more transparent regime by publishing both gross and net reserves, thereby increasing the credibility and reducing market fears.

Mr. Al-Tuwaijri made the following statement:

While Russia has enormous potential, realizing this potential is fraught with challenges. Overcoming those challenges will bring substantial benefits not only to the Russian population but also to the world at large. Failure can have disastrous consequences. Therefore, every effort should be made to help Russia succeed. It is in this spirit that I support the proposed decision.

The root causes of the Russian economic difficulties—large government borrowing requirements and uneven progress in structural reform—are well known to the authorities, staff, management, and the Board. However, despite a number of Fund programs and countless measures by the authorities, the results in addressing those root causes are at best mixed. Indeed, it is most disappointing that the federal government revenue targets were once again missed.

The main lesson to be learned from the Russian experience is that while passing the agreed laws and decrees is a necessary condition, it is not sufficient for realizing the program's objectives. Therefore, the current program, despite its strength and the long list of prior actions, can only succeed with effective enforcement of the agreed policies. I am afraid that the Duma's limited support would continue to limit prospects for effective enforcement of the program.

Let me conclude by making three general comments.

First, the large and increasing exposure of the Fund to a single borrower is a concern. This will not only increase the risks but, given the low level of liquidity, could affect the level of access of other members to Fund resources.

Second, frequent changes in program targets and frequent granting of waivers could undermine the credibility of Fund programs. It is important that Fund program's targets and objectives be realistic and that the implementation capacity of the country be fully taken into account.

Third, it is important when formulating our policies with a member to keep in mind the principle of comparable treatment for all members.

With these remarks, I wish the authorities the best in meeting the difficult challenges ahead.

Mr. Rouai made the following statement:

Paragraph 1 of the letter of intent summarizes the root causes of the severe financial pressures affecting Russia. While I agree that there is a combination of exogenous and endogenous factors behind the current crisis, I believe that domestic factors played a more dominant role: First, commitment to reforms in Russia was not strongly supported, nor widely shared within the government or in parliament. Second, I tend to share the view expressed by Mr. Mozhin regarding the unique circumstances of the Russian economy, including the special distortions affecting the real sector. Under these internal circumstances, it is not surprising that after two SBAs and one EFF in the last seven years and despite the remarkable progress in reducing inflation, the Russian economy is not in a position to weather the contagious effect of the Asian crisis and the decline in international oil prices.

I would like to comment briefly on some fragile areas in the Russian economy, namely, the enterprise sector, the fiscal program, the debt conversion mechanism, and the banking sector.

On the enterprise sector, Mr. Mozhin candidly admits "that, so far, many if not most Russian enterprises outside the resource sector have failed to adjust to the conditions of a market economy." He also adds, "it is practically impossible to distinguish viable enterprises from the non-viable." My question is: how confident is the staff with the current program, and could it effectively

deal with the issue of the enterprise sector and break the cycle of wages and tax arrears?

On the fiscal program, both the letter of intent and Mr. Mozhin statement strongly indicate that the radical tightening of the federal budget "will solve once and for all persistent fiscal imbalances." I am very encouraged by this commitment, which is reflected in the agreement on a tough fiscal adjustment and in the good-faith efforts made by the new Government in pushing this program through the Duma. In my view, however, the success of this program rests not only on the adoption of the fiscal program, but more importantly on its implementation and on the improvement in tax administration and collection. The projected increase in tax revenues is an important benchmark. Equally important is the broadening of the tax base and the development of a tradition of a civic tax culture. I would appreciate staff comments on the status of tax compliance in Russia and its prospects under the program. It could also be useful if the staff and the authorities would design and monitor indicators on tax compliance. Also, could the staff elaborate on the role of tax agents and their ability to withhold taxes?

The issue of treasury bills highlights again the risks associated with early liberalization of short-term capital movements. It is unfortunate that this issue mushroomed while the country is under Fund program. The emergency program includes a debt conversion mechanism to lengthen the maturity of the domestic debt. It is assumed that if confidence should be restored, holders of GKO's will no longer seek participation in the scheme. If this is the case, the objective of lengthening the maturity of short-term debt will not be achieved, and the ruble will remain subject to shifts under market sentiment. There are three concerns associated with this conversion: first, it is not clear that it will help reduce the final cost for the budget; second, there is an immediate risk of further increasing external debt; and, third, for resident commercial banks, such conversion could limit their liquidity management ability. In addition, it could even prove to be unhelpful since, by freezing their deposit base for a longer period, it would reinforce the incentives to crowding out the private sector.

The situation of the banking sector is perhaps the most fragile area because it could potentially aggravate the country's fiscal position. I am particularly concerned by the fact that there is no indication of the extent of the problem. There is no hint in the staff report of the magnitude of the non-performing loans. Also, banks remain exposed to foreign currency positions and defaults in off-balance sheet contracts. The program adopted by the authorities to deal with problem banks is of a temporary and not a comprehensive nature and is financed outside the budget.

Before concluding, I would like to comment on the Annex to the report on the relations with the World Bank group. This annex is the same one included in the paper for the seventh review, with data still referring to operations as of end-April 1998. In addition, this annex should focus more instead of refer constantly to the history of the relations with the country. It would have been useful for today's discussion to know which reforms, or

sectors will benefit from the World Bank contribution of \$1.1 billion in 1998-99.

I welcome the authorities' decision to publish the letter of intent. Paragraph 5 of the letter should however be reviewed in accordance with the new schedule of purchases.

In conclusion, I am pleased to see that the CCFF is still a useful facility for timely balance of payment support. I support the proposed decisions and wish the Russian authorities success in their endeavors.

Mr. Eyzaguirre made the following statement:

I join previous speakers in commending staff and management for their extraordinary efforts in helping the Russian authorities strengthen their program. The delays in taking important policy decisions in many areas, particularly the tax system, when building up dangerously high fiscal deficits clouded the transition process. More recently, persistent capital outflows have led to steep increases in interest rates, heightening the fiscal situation and devouring the limited economic recovery. Moreover, Russia's economic condition tended to deteriorate further before the announced comprehensive and well-funded program with the Fund. In this context, the comments made by this chair at the time of the seventh quarterly review three weeks ago are maintained in their entirety.

Against this backdrop, we are encouraged by the authorities' determination to approve an enhanced policy package to overcome the current difficulties, based on, primarily, a drastic fiscal tightening to convince markets that their fiscal position is sustainable in the medium term and that their overall deficit can be financed. Given the comprehensive assessment of Russia's economic prospects by staff, and the comments of previous speakers, I will confine my intervention to a few points for emphasis.

The Central Bank of Russia's intention to continue with its monetary and exchange rate policy, broadly unchanged, for the remainder of 1998 seems appropriate considering the anchoring role of the exchange rate and that the banking system remains significantly exposed to foreign currency and related counterpart risk. The firm implementation of the program should permit a recovery in gross international reserves as confidence returns and capital flows turn around. However, we see with concern the announced continuation by the CBR of providing liquidity assistance to facilitate the adjustment of systematically important problem banks. Those operations also may jeopardize the conduct of an appropriate monetary policy. In this regard, we share the staff view on the need to move quickly in addressing immediately the problems of systemically important banks. We also consider urgent the adoption of strong prudential regulations in the banking system, specially the ones aimed at limiting exchange rate and credit risk.

Among the measures adopted on tax policy, we particularly noted the establishment of a temporary uniform 3 percent import duty surcharge. In this

regard, we understand the fiscal need, but at the same time, we underscore the adverse effect on Russia's competitiveness. Thus, we would underscore the convenience of its early elimination, if possible before the end-1999.

Two factors emerge clearly from the program's financial magnitude. First, its systemic importance and second, the exceptional risks the Fund is undertaking in Russia. It is evident for the system that a major financial crisis in Russia would be severely costly; however, Russia's permanent vulnerability and procrastination in the implementation of necessary structural adjustments in its economy would be more costly. In all countries the appropriate measures are taken only when there is no other measure to adopt, we sincerely hope that as Mr. Mozhin said, this time "there is simply no alternative". From the program access, financing, and phasing emerges an enhanced role for the Fund, no longer catalytic, but as a leading participant. Considering the projected liabilities to the Fund would represent about 18 percent of Russia's convertible currency debt and the equivalent of 32 percent of exports. The possibility that the Duma challenges in the near future the measures recently passed is a matter of particular concern. Regarding the program's exceptional risks, only a strong and determined policy implementation of the package of measures adopted will safeguard Fund resources. We join the staff and management in urging the highest authorities in Russia to embrace policy implementation in public finances, governance, and banking sector reform with unfailing energy and determination.

With these remarks, this chair supports the proposed decision and wishes the Russian authorities every success in the implementation of the recently announced anti-crisis program and of critical pending structural reforms.

Mr. Morais made the following statement:

The staff report and the authorities' letter of intent outline a strong program, with the appropriate emphasis on improving fiscal performance. Efforts are also being made to move forward with structural reform. The program, together with the demonstrated balance of payments need, justifies an increased support from the Fund.

The question that remains concerns the ability of the government to fully implement the program. Since the matter is to restore market confidence, then support for the program across the broad spectrum of the Russian society, especially the political leadership, is crucial to sending the right signal. The prior actions were intended to show political support for the program. Like other speakers, I wonder whether the staff are satisfied with the level of ownership demonstrated so far?

The difficult transition process in Russia continues to point to the need for developing and strengthening institutional capacity. The recognition that this will take longer than expected is a step in the right direction and is consistent with the medium-term framework that is being envisaged.

It is also important that the medium-term framework give priority to economic growth. The slow recovery in Russia has added to the problem of fiscal consolidation. It also complicates the process of generating enthusiasm for reform.

I welcome the flexibility of the Fund in dealing with Russia and some of the other recent cases. The fact that progress is being made in these countries is evidence that even when all conditions are not right the Fund can still work with the authorities to advance the process of reform. We should see more of this.

I support the proposed decision, and wish the Russian authorities well in their endeavors.

Mr. Barro Chambrier made the following statement:

At this juncture, I can be brief.

While recognizing that the financial market turmoil in Asia and the weak export performance have had adverse effects on the Russian economy, we believe that it is important for the Russian authorities to address issues which are under their control. We also think that it is time for Russia to implement steadfastly the measures contemplated in the program. Russia should show a greater sense of ownership with regard to the needed strengthening of the public finances at the local and federal levels. It is also of paramount importance to improve governance, and accelerate the restructuring of the banking system.

Like previous speakers, we agree that the additional financial assistance that is envisaged should not be a substitute for a major strengthening of the program's implementation. We also share the view that to address the current difficulty a strong political backing is needed as well as from the parliamentary body than from the executive one. A broad consensus is clearly needed around the proposed program.

We are, however, encouraged to learn from Mr. Mozhin's very informative buff statement that the main result of the current financial crisis in Russia is that, almost everybody understands the rationale for the proposed program. Clearly, Russia is at a cross road and the Fund's exposure in Russia is very high and put some risks on our strategy. Our room of maneuver is very limited.

That is why we wish the Russian authorities every success in their daunting task of restoring market confidence and accelerating the pace of the transformation of the economic system.

Ms. Abdelati made the following statement:

It appears that a major effort has been mounted by the Russian authorities to put together a strong set of policies, which we hope will address

the deteriorating economic situation and place the economy on a sound path for growth. Given the exceptionally high Fund exposure, it would have been preferable if Russia had demonstrated a better record of policy implementation. In this regard, we share the discomfort and concerns expressed by Mr. Giustiniani, and we note with concern that only 15 of the 30 structural measures have been completed. Nevertheless, being fully aware of the implications of a possible deepening of the financial crisis, we can reluctantly support Russia's request on pragmatic grounds.

This is an opportune time for the Russian authorities to push ahead with steadfast implementation of the program. Mr. Mozhin offers three convincing reasons for the still large fiscal deficit in Russia: policy disagreements within the government; the joint responsibility between the cabinet and parliament for fiscal policy; and, the spillover effect from the enterprise sector. Mr. Mozhin assures us that the first issue is no longer a concern, since the newly formed cabinet has a coherent agenda. He does not suggest, however, that the risks associated with the second and third reasons have been altogether resolved. Could the staff provide an assessment of the second and third issues of concern mentioned by Mr. Mozhin, and their implications for achieving the fiscal targets of the program for 1998 and 1999.

The sizable risks of the Russian program to the Fund calls for exceptional efforts by the authorities to address the vulnerability of the Russian economy to external shocks. Swift and resolute actions are needed to strengthen the resilience of the economy to withstand shocks and restore market confidence.

We hope that the expressed commitment of the authorities supported by the efforts of the staff, will translate into the implementation of radical reforms that will bring about a lasting improvement in Russia's budgetary finances, in banking soundness, and in the accountability of enterprise operations. We wish the authorities success in these efforts.

Mr. Harinowo made the following statement:

At the outset, we thank the staff for their comprehensive report and the excellent job done. Their thorough and relentless efforts are highly appreciated. We are in broad agreement with the general thrust of the staff's assessment and would be brief.

It is regrettable that the Russian Federation is facing such a grave situation. The Asian crises is one important factor that made the Russia's underlying flaws on the economic fundamental became so exposed. Together with the fall of oil prices and other home grown problems made them as the target of speculative attacks. There is therefore urgent need to take corrective measures in order to correct the circumstances caused by internal factors.

As this chair has often stated in the past, correcting the fiscal imbalance remains the main issue in stabilizing the Russian economy. There is need to improve both revenue and expenditure. We welcome the authorities' intention

to improve revenue by strengthening tax administration and changing tax policy and we encourage them not to waiver from their determination to take strong measures for improvement in revenue. On the expenditure side, the authorities' desire to further strengthen expenditure control is most welcomed. We hope that the federal treasury system can be effectively developed and that the authorities can achieve their target of bringing all spending units, including the Ministry of Defense, under the control of the Treasury, successfully, by January 1, 1999, as planned.

On the monetary and exchange policy, we concur with the staff and the authorities that the present policies, which have helped dampen and brought down inflation, should remain broadly unchanged, at least until the end of the year. However, undertaking comprehensive measures is urgently needed to improve weaknesses in the banking sector so as to develop and ensure a sound and reliable system, which will be able to implement effective monetary policy. In this regard, we reiterate once again that prudential supervision of banks and banking surveillance need to be strengthened and increased and any necessary reinforcement on the banking law be instituted. On measures to deal with problem banks, we can understand the need for addressing the problems of systemically important banks by providing liquidity for them to merge with other healthy banks. But we would urge the authorities to practice a strategy of taking strong administrative action without financial assistance.

We are encouraged by the letter of intent and commend the authorities for their commitment toward taking and implementing prudent and strong adjustment actions. Although it is true that the Russian Federation is facing hardships, it is not the only country which is a victim of bad luck as there are also other countries which are facing grave problems, although the magnitude may not be the same.

Taking into consideration the risks that can occur and the very substantial amount of financial assistance involved, every caution is necessary because any small slippage in the implementation of the adjustment measures can jeopardize the whole program.

Our chair can go along with the proposed decision and hope that the program could be implemented successfully.

Finally, we wish the authorities every success in their very difficult challenges ahead.

The Director of the European II Department noted that the program was strong and that the government was firmly committed to it. Its implementation should be better than that of previous programs for several reasons. First, the tax administration system had been improving gradually. Second, the system of expenditure control was much stronger than a year previously, and improvements continued to be made. Third, there was much more unity in the government. The president was also more closely involved with the program. Fourth, while the Duma had rejected two measures, it had also passed a number of measures, and had been quite supportive of the program.

While an adverse reaction in the markets to the program could be expected in the short run, over time the current program should strengthen the credibility of the Fund and its role in Russia, the Director noted. A supplementary letter of intent had recently been signed by Prime Minister Kiriyenko, which requested a change in the phasing of payments. The letter noted that the timetable for implementation of policies was different from that in the original memorandum as set out in the supplementary paper, and it included a supplementary memorandum of economic policies which the authorities intended to publish. Those items would be placed on the web site of the finance ministry tomorrow. The two letters of intent would, however, not be published.

The Deputy Director of the European II Department commented that the situation of the banking system was an issue of concern for the staff, and it would be working closely with the authorities to make a diagnosis of the current situation.

Of the 30 largest banks in Russia, 86 percent of the loans were fully performing, the Deputy Director reported. On average, the banks were in a satisfactory position. However, exposure to changes in the exchange rate could be quite serious. Three types of transactions could lead to problems in this area: the exposure of the banking system in foreign currency, the extent to which foreign borrowing was oriented in domestic currency, and the problems that could arise through forward contracts in foreign currency. The latter was of particular concern to the authorities, and the central bank had been working actively toward introducing better practices for the issuance and pricing of forward contracts.

The Director of the European II Department stated that in conjunction with the debt conversion scheme the staff considered that it was essential that there should be a reduction in debt interest payments, and that there should be a lengthening of maturities. The staff also considered it appropriate to have a shift toward foreign currency rather than domestic currency liabilities. While that placed Russia in a vulnerable position in the event of changes in the exchange rate over the medium and long term, that was a risk that must be accepted.

While Russia could have received a better deal from the debt conversion scheme had it been mandatory, at a price that would have been more favorable to Russia, the broader consequences of such a policy could be quite serious, the Director considered.

Mr. Sobel recalled that there had been a consideration of a debt conversion scheme for Sberbank and the central bank. Could the staff elaborate on whether that would be implemented, and whether it would benefit those banks.

The Deputy Director of the European II Department explained that the debt conversion scheme intended to transform the Sberbank holdings of GKO's into longer than one-year maturity paper. More information on what would be done with the portfolios of GKO's of the Sberbank and central bank was not currently available. For the Sberbank, this conversion scheme would probably be useful because it could convert some of the shorter-term debt into longer-term debt. No strong need existed to change the GKO's for the central bank, because it cooperated with the government. Whenever the government could not sell paper, the central bank would take that paper. Therefore, to the extent that the central bank was not issuing any more one-year paper, at least for now, the central bank would not be adding to its GKO holdings.

Mr. Yakusha wondered whether the staff could comment on the impact of the Russian authorities' intent to discontinue issuing short-term paper on commercial banks' liquidity management'.

The Deputy Director of the European II Department noted that the intention of the authorities was not to issue any more paper with maturities of less than one year. However, the authorities and staff had agreed that, in the context of the formulation of the 1999 EFF-supported program, there would be a reassessment of both the government's access to capital markets and the maturity structure of paper in the market.

Mr. Yoshimura considered that a delay in disbursements of the first tranche for 10 days would be appropriate. The Russian situation did not appear to involve the private sector sufficiently in burden sharing. The Fund would probably be criticized for that, in particular in view of the lessons that had been learned from the Asian crisis.

Mr. Askari-Rankouhi wondered to what extent the markets were aware of the original rephasing of payments to Russia.

The Acting Chairman noted that markets were completely aware of the rephasing of payments to Russia.

While a disbursement delay of 10 days was a viable option, it might produce a highly adverse reaction by the Duma, the Acting Chairman considered. While moral hazard was definitely an issue in the case of Russia, the negotiations with the Russian government had helped bring coherence to Russian government policy. Furthermore, the markets had put enormous pressure on the Russian government, which had helped to implement some of the strong demands under the program. The exposure of the Fund as a result of the program was of concern to staff, management, and Directors alike. The Fund was facing a difficult situation and needed to take a fundamental decision on whether or not to support the ruble. The decision to support the ruble in the Fund program was taken after careful calculation, and was considered to be the best policy option available.

Mr. Hansen commented that while Mr. Yoshimura's and Mr. Kiekens's arguments to delay the first tranche for 10 days were appealing, it would be preferable not to incite an adverse reaction from the Duma. Therefore the proposed decision should not be postponed.

Mr. Rouai said that he supported the rephasing proposed by the staff, and did not consider that delaying the first part of the first purchase would be beneficial because it could lead to adverse market reaction.

Messrs. Esdar and Milleron also considered that the proposed phasing by the staff was appropriate.

Mr. Mozhin considered that the Duma session held the previous week was a big step forward. The Duma had approved a number of key decisions, such as the first part of the new tax code, and the new budget code. The two important pieces of legislation that failed to pass, failed by only a couple of votes. One of the key complaints of the Duma, and which might have contributed to the failure to pass the two pieces of legislation, was that the government did not provide the full text of the Fund agreement to the parliament. The reason the full text had not been submitted was that the original anticrisis program had been submitted to the

Duma, and the authorities and the Fund staff realized that a much broader package was necessary, in particular concerning the fiscal requirements. Some of the necessary measures had no chance of being supported in the Duma. By the time of the next emergency session of the Duma in mid-August, all the deputies would have the full information of what had been agreed on with the Fund.

The authorities realized that the decision taken by the Board on Russia was perhaps one of the most risky decisions in the history of the institution, Mr. Mozhin noted. The authorities fully understood that it was their last chance, and that if they failed, there would be no other opportunity.

The Secretary stated that the decision on the Extended Arrangement would be amended to reflect the reduction in the first purchase amount, and the consequent changes in the phasing of purchases. A Secretary's understanding would be issued to reflect the changes in the proposed decision.

The Acting Chairman said that the following points would be reflected in management's statement after the Board meeting:

First, Directors considered that the enhanced policy package represented a strong and appropriate response to dealing with Russia's current difficulties, and they welcomed the government's efforts to secure political support for those actions, with an emphasis on the strengthening of fiscal policy and the accumulation of international reserves.

Second, Directors regretted that parliamentary backing had not been forthcoming for actions relating to personal income tax and measures to strengthen the finances of the pension fund, but welcomed the intention of the government to seek parliamentary approval of those measures in a special session of the parliament scheduled for August, 1998.

Third, owing to the delay in implementing those actions, the Fund was reducing the amount being made available in the first tranche from \$5.6 billion to \$4.8 billion. The difference would be made available in September, if the measures were satisfactorily implemented in the meantime.

Fourth, Directors considered that the laws adopted over the past few days would lay a solid basis for fundamental improvement in Russia's fiscal position and the revitalization of structural reforms, but stressed that the government would need to ensure full implementation of the policies envisaged in the program and the associated legislation. Directors noted that weaknesses in implementation had been the Achilles' heel of Russia's economic policies in the past, and thus emphasized that it was critical that Russia take advantage of the opportunity to make fundamental changes in economic policy.

Fifth, Directors supported the intention of continuing the existing exchange rate and monetary policy strategies. In discussing banking issues, Directors urged the central bank of Russia to move ahead rapidly to put in place a solid bank restructuring framework.

Finally, Directors welcomed the authorities' decision to request a successor EFF arrangement for 1999-2001, this could help assist the continuation of reforms in a period that would see important political changes in Russia and that request would be considered in due course.

Messrs. Yoshimura, Kiekens, Taylor and Giustiniani considered that the statement made by the Acting Chairman was too positive and that if it were not to capture fully all aspects of the discussion at the Board, the statement should be published as the responsibility of management.

The Acting Chairman agreed that the statement should be published by management, in particular because most Directors agreed only reluctantly to the program with Russia.

The Executive Board took the following decisions:

Extended Arrangement—Augmentation

1. In letters from the Prime Minister of the Russian Federation dated July 16, 1998, with the attached memorandum of the government of the Russian Federation and the Central Bank of the Russian Federation on Economic and Financial Stabilization Policies for 1998, and dated July 20, 1998, with the attached supplementary memorandum, the Russian Federation has requested an augmentation and rephasing of purchases to be made available under the Extended Arrangement for the Russian Federation (EBS/96/31, Sup. 6), as amended.

2. The letters of the Prime Minister of the Russian Federation dated July 16, 1998 and July 20, 1998 (with their attached memoranda), shall be attached to the Extended Arrangement, and the letters dated March 6, 1996, with its attached statement, and March 12, 1996, as modified, shall be read as supplemented and modified by the letters dated July 16, 1998 and July 20, 1998 (and their attached memoranda).

3. The Fund approves the request. Accordingly,

a. The Extended Arrangement for the Russian Federation shall be augmented by the equivalent of SDR 6,305.570 million. To that effect, paragraph 1 of the Extended Arrangement shall be amended by replacing "SDR 6,901,000,000" with "SDR 13,206.570 million";

b. Paragraph 2 on the phasing of purchases under the Extended Arrangement shall be amended to read as follows:

"2(a). Purchases under this Extended Arrangement shall not, without the consent of the Fund exceed the equivalent of SDR 12,141.834 million until March 31, 1999, provided that purchases shall not exceed the equivalent of SDR 5,779.714 million¹ until September 1,

¹Includes SDR 4,336.264 million already purchased plus SDR 768.43 million to be made available under the Extended Arrangement and SDR 675.020 million to be made available under the Supplemental Reserve Facility upon approval of the augmentation of the Extended Arrangement.

1998, the equivalent of SDR 9,026.304 million until December 1, 1998, and the equivalent of SDR 11,641.834 million, until February 15, 1999.

The right of the Russian Federation to make purchases under the remaining period of the arrangement shall be subject to such phasing as shall be determined."

c. In order to identify which amounts of each purchase will be made available under the terms and conditions of the Supplemental Reserve Facility, the following paragraph 2(b) shall be added to the Extended Arrangement:

"2(b). Of the augmented amount to be provided under the Extended Arrangement, the equivalent of SDR 3,992.470 million shall be made available until July 19, 1999 under the terms and conditions of Decision No. 11627-(97/123), adopted December 17, 1997, on the Supplemental Reserve Facility (the SRF), as follows:

(i) the equivalent of SDR 675.020 million, upon approval of the augmentation of the Extended Arrangement,

(ii) the equivalent of SDR 1,806.280 million, with the purchase scheduled for September 1, 1998, and

(iii) the equivalent of SDR 1,511.170 million, with the purchase scheduled for December 1, 1998.

All other amounts to be made available under this Extended Arrangement shall be made available under the terms of Decision No. 4377-(74/144), adopted September 13, 1974, on the Extended Fund Facility."

d. The following shall be added to the standard paragraph 4 on suspension of purchases: "or, (e) pursuant to paragraph 6 of Decision No. 11627-(97/123), adopted December 17, 1997, on the Supplemental Reserve Facility,"

e. The performance criteria for September 30 and December 31, 1998 set forth in paragraphs 3(a)(i) on net domestic assets, 3(a)(ii) on net claims of the Monetary Authorities on the Enlarged Government, 3(a)(iii) on net claims of the Monetary Authorities on the Federal Government, and 3(a)(vi) on net international reserves, of the Extended Arrangement, shall be as specified in paragraph 8 and Table 1 of the memorandum attached to the letter dated July 16, 1998.

4. Notwithstanding the nonavailability of data regarding the performance criteria for end-June 1998 set forth in paragraph 3(a) of the Extended Arrangement, the Russian Federation may proceed to purchase the

equivalent of SDR 1,443.45 million under the arrangement, until July 27, 1998. (EBS/98/120, Sup. 1, 7/17/98)

Decision No. 11765-(98/79), adopted
July 20, 1998

Purchase Transaction—Compensatory and Contingency Financing Facility

1. The Fund has received a request by the government of the Russian Federation for a purchase equivalent to SDR 2,156.55 million for the compensatory financing of a shortfall in export earnings under Section II of the Decision on the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988, as amended).

2. The Fund approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).
(EBS/98/120, Sup. 1, 7/17/98)

Decision No. 11766-(98/79), adopted
July 20, 1998

4. GENERAL ARRANGEMENTS TO BORROW—ACTIVATION

The Executive Directors considered a staff paper on the Managing Director's proposal regarding activation of the General Arrangements to Borrow for the Russian Federation (EBS/98/123, 7/17/98).

Mr. Esdar accepted the proposal of the Managing Director regarding the activation of the General Arrangements to Borrow for the Russian Federation based on the Acting Managing Director's confirmation on July 15 that the Managing Director would initiate early repayments in accordance with paragraph 11B of the General Arrangements to Borrow, promptly following payment for the bulk of quota increases once the Eleventh General Review of Quotas came into effect.

Messrs. Yakusha, Cippà, Giustiniani, Hansen, and Kiekens agreed with Mr. Esdar.

The Treasurer noted that the amount to be called under the General Arrangements to Borrow, which would be in proportion to the amount of the new phasing for the Extended Fund Facility, and for the Supplemental Reserve Facility, would be initiated that night for value on Wednesday, except for Japan. Japan would deliver the resources to Russia on Thursday.

The Executive Board took the following decision:

Pursuant to paragraph 7(a) of the General Arrangements to Borrow, the Executive Board approves the Managing Director's proposal of July 14, 1998 set forth in the attachment to EBS/98/123 (7/17/98) for future calls for exchange transactions under the current Extended Arrangement for the Russian Federation

(EBS/96/31, Sup. 6, 4/2/96) as amended, including the amendments approved by the Executive Board on July 20, 1998 at Executive Board Meeting 98/79.

Decision No. 11767-(98/79) adopted
July 20, 1998

5. OPERATIONAL BUDGET FOR JUNE-AUGUST 1998— ENLARGEMENT

The Executive Directors considered a staff paper proposing an enlargement of the operational budget for June–August 1998 (EBS/98/122, 7/16/98).

Mrs. Farid noted that in view of the sharp decrease in oil prices, the United Arab Emirates regretted that their balance of payments situation did not permit their participation in the operational budget for June-August 1998.

Mr. Giustiniani considered that a clear case existed to review the system by which the operational budget spread the burden among countries

The Treasurer noted that two opportunities would arise to review the system of contributions to the operational budget. First, there would be a Board meeting on assessing balance of payments needs in the context of the monetary union in Europe, which was scheduled for September 16. Second, the Board would review the allocation of currencies under the operational budget more generally, no later than end-1998, or earlier when the quota increase came into effect.

With respect to the nonparticipation of the United Arab Emirates, the staff considered that, despite the rise in the current account deficit, the size of reserves of the United Arab Emirates would enable them to contribute to the operational budget, the Treasurer remarked. The Board was in a position to consider the request of the United Arab Emirates.

Mr. Al-Tuwaijri considered the request by the United Arab Emirates legitimate, in view of the sharp decrease in oil prices.

Mr. Rouai supported the United Arab Emirates' request not to participate in the operational budget.

Mr. Cippà wondered whether the amount that the United Arab Emirates did not contribute would be distributed proportionately to the other participants in the operational budget.

The Treasurer noted that the contribution of the United Arab Emirates was small in relation to the total, and suggested that, if the Board decided to exclude the United Arab Emirates, its allocation could simply be subtracted from the total.

The Secretary noted that a Secretary's understanding would be issued to reflect the changes in the operational budget.

The Executive Board took the following decision:

The Executive Board approves the amendment to the operational budget for the quarterly period June–August 1998 (Executive Board Decision No. 11732-(98/58), adopted May 27, 1998) set out in Table 1 of EBS/98/122, Supplement 1 (7/22/98).

Decision No. 11768-(98/79) adopted
July 20, 1998

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/98/78 (7/17/98) and EBM/98/79 (7/20/98).

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by Assistants to Executive Directors as set forth in EBAM/98/129 (7/16/98) is approved.

APPROVAL: July 12, 2000

SHAIENDRA J. ANJARIA
Secretary